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THE ARGENTINIAN DEBT

HEARING

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL FINANCE
AND MONETARY POLICY

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ON

DETAILS AND IMPLICATIONS OF U.S. GOVERNMENT INVOLVEMENT IN BOTH THE ARGENTINIAN AND THE LARGER LATIN AMERICAN DEBT CRISES

MAY 3, 1984

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THE ARGENTINIAN DEBT

THURSDAY, MAY 3, 1984

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY,

Washington, D.C.

The committee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Mack Mattingly presiding.

Present: Senators Mattingly, Heinz, Hecht, Proxmire, Riegle, Sasser, and Lautenberg.

Senator MATTINGLY. The Subcommittee on International Finance and Monetary Policy, and I will yield to Senator Heinz for a statement.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, first I want to thank you very much for chairing this subcommittee. As my friend from Georgia knows, the Senate Finance Committee has a markup at 9:45 dealing, among other things, with the generalized system of preferences and the customs authorization. I asked the Senator from Georgia to chair this hearing because I could not be here for it.

It does deal with an important subject, namely, the Argentine economic and financial situation and the debt situation in that country. The hearing was requested of me and the committee by Senator Proxmire and other members of the minority and it's our custom to accommodate the members of the committee, either majority or minority, when they have an interest in the subject.

I am deeply indebted to you, Senator Mattingly, for taking me off the hook and chairing this hearing in my absence. I want to extend my apologies to our witnesses, particularly Tony Solomon, who has been not only a frequent witness here on Capitol Hill, but has served with great distinction in at least two administrations. He happens to be, among other things, a former professor of mine from the Harvard Business School, Bill Proxmire——

Senator PROXMIRE. Nobody is perfect.

Senator HEINZ. And there's a certain irony in the fact that prior to the hearing commencing this morning, Governor Solomon informed me with his usual modesty that he was the father of the generalized system of preferences [GSP] program during the Johnson administration, which is one of the items that we're marking up in the Finance Committee this morning.

So, Senator Mattingly, thank you very much for your willingness to chair this hearing. I thank you, commend you, and wish you well, and wish I could be here.

Senator **Mattingly**. Thank you very much, Senator Heinz. It proves one thing—you can't be in two places at once. I wish I was down there helping you testify on the GSP because I think that's going to be quite an issue this year.

Senator **Heinz**. You may want to discuss that with Mr. Solomon.

OPENING STATEMENT OF SENATOR MATTINGLY

Senator **Mattingly**. Today, the Subcommittee on International Finance and Monetary Policy is going to look at the recent Argentine debt package which was put together in the closing days of March. As Senator Heinz, who is the chairman of the subcommittee, has this conflict, he asked me to chair this and I'm quite willing to do so since this is a subject of great interest and concern to me.

The Latin American debt crisis affects all Americans, both because of its political and its financial implications. My own State of Georgia, who has been a major exporter of both agricultural and manufactured products, has been profoundly affected by the crisis.

Today spokesmen from the administration and the Federal Reserve System will discuss the details and the implications of both the Argentina debt situation and the larger Latin American financial crisis. The subcommittee is particularly interested in the role of the U.S. Government in working out the final package.

One observer described the recent performance of the United States and the Latin American governments who put together the last-minute rescue package much like watching a circus performer dangling upside down with his foot tangled in the high wire—the show was interesting and very exciting, but one is not sure if he was watching a brilliant performance or just sort of clumsy luck, and that is how many of us on the committee felt as we heard the news of the Argentine loan package. We weren't quite sure how to interpret our Government's performance. That's why we're having this hearing today.

Despite the skill of the administration's performance, a number of serious questions must be asked. Was the exchange stabilization fund the proper vehicle for U.S. participation in the loan package? What is the contingent liability of the United States and the risk to the taxpayers' dollar? Was it Argentina's democracy or Citibank's profits that were most at risk at the end of March? And if democracy and human rights in Argentina are really at stake, why are the U.S. commercial banks rather than the U.S. Government making the key decisions regarding the viability of the new Argentine Government and what are the implications of the current Argentine debt crisis for the larger debt crisis in Latin America?

If there is a light at the end of the tunnel, we hope it's not the headlights of an oncoming train. The IMF quota increase which Congress passed with such great difficulty last year was, I'm afraid, only the beginning of the solution to the great problems of international debt.

The questions which I've posed are ones I would hope our distinguished witnesses will help us to answer. There are several questions that must be answered if we are going to pursue a rational policy regarding not only the immediate but the long-term problem of the international debt.

With that, Senator Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator **Proxmire**. Thank you, Mr. Chairman.

Mr. Chairman, I have an opening statement. I'm going to stay as long as I can. I have to leave at 10 o'clock but I will come back by 10:20 or 10:30 I hope. I have to make a statement on the floor and I will come back here as soon as I can.

As we start this hearing we welcome recent positive developments in Argentina that led to the inauguration of the democratically elected government of President Raul Alfonsin on December 10, 1983. Our Government should be as supportive as we can of that new regime.

Shortly after assuming power, the new Alfonsin government began discussions with the IMF on a new adjustment program in order to help clear up the shambles in which the previous military regime left the economy. The Argentine Government hopefully can work with the IMF to design a program that can restore conditions for economic growth and price stability in Argentina and give foreign lenders confidence in the direction of Argentina's economic policy. Such a belt-tightening program will require sacrifices by the Argentine people, but the long-term results will be very positive. The International Monetary Fund [IMF] bill we passed last year calls on our Government to work within the IMF for policies that can resolve the debt crisis, but not at the same time press debtor countries to the wall for the benefit of exposed banks.

Recent developments in debtor countries such as Mexico and Brazil show they have made progress in implementing IMF agreed upon programs. These countries thereby benefited from renewed confidence by private lenders and thus gained better terms on their restructured loans. The international debt situation is not something that any of us welcome, and neither the debtor countries nor the involved banks can expect to resolve it without mutual discomfort.

We urged that today's hearing be held in order to provide Congress with an opportunity to update itself on developments in this area in general, and in particular to find out more about recent arrangements, in which our Government was involved, that enabled the Government of Argentina to obtain bridge financing to pay commercial banks $500 million in interest due on its international loans on March 31, 1984.

It seems that as part of this arrangement Mexico, Venezuela, Brazil, and Colombia combined to lend Argentina $300 million for an interim period while Argentina works out its long-term financial program with the IMF. Argentina included the $300 million in the $500 million package it paid in interest to its creditor banks on March 31, 1984. Once Argentina signs its Letter of Intent with the IMF the United States will provide President Alfonsin's government with $300 million from our exchange stabilization fund so that Government can pay off its $300 million in bridge loans from other Latin nations.

Congress never appropriated one dime of the $300 million furnished by our Government that may be at work here. So what is the legal authority upon which the administration relied in making the commitment of money to Argentina? Do the parameters of such legal authority, if it exists, need to be tightened? What is the nature of the risk involved to our taxpayers in making that money available to Argentina? Do our taxpayers assume risks so that Argentina can have money to pay off U.S. banks? Most taxpayers do not receive a portion of the profits made by our banks on such loans, and neither should they be expected to absorb the banks' losses.

Has our Government created a possible conflict of interest for itself in providing that money to Argentina? Section 806 of last year's IMF bill requires the administration to work against any economic adjustment program that ties up more than 85 percent of a debtor country's export earnings. If Argentina should sign a letter of intent tying up a larger share of its export earnings, it appears we would have to oppose it, even if we thereby placed the $300 million we plan to loan to Argentina at risk. So we should look at this matter carefully.

With that, I'm delighted to see our distinguished witnesses and we're fortunate to have two and I hope three such able people appearing before us. Thank you, Mr. Chairman.

Senator MATTINGLY. Senator Lautenberg, do you have an opening statement?

Senator LAUTENBERG. No, thank you, Mr. Chairman.

Senator MATTINGLY. Senator Sasser.

Senator SASSER. No, Mr. Chairman. Thank you.

Senator MATTINGLY. With that, I welcome Mr. Mulford and Mr. Solomon and you may make your statements. If you would like to submit them for the record you can do that and maybe you can summarize them.

STATEMENT OF DAVID C. MULFORD, ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY

Mr. **Mulford**. Good morning, Mr. Chairman. I have a statement which I would like to read, with your permission.

Senator **Mattingly**. Very good.

[The complete statement follows:]

Mr. Chairman, I welcome the opportunity to appear before this Subcommittee to discuss Argentina's economic and financial situation and the short-term financing package in support of Argentina's adjustment effort.

DEBT STRATEGY

Before discussing Argentina's particular circumstances, I would like to review briefly for you the U.S. Government's strategy for dealing with the problems of international indebtedness. This strategy was first enunciated in late 1982 in the wake of the Mexican debt crisis. It was endorsed by the seven heads of state at the Williamsburg Summit last year, and has wide support throughout the international financial community.

The strategy consists of five elements: (1) economic adjustment by the debtor countries; (2) economic recovery and sustained growth and open markets in the industralized countries; (3) adequate resources for the International Monetary Fund (IMF); (4) continued commercial bank lending for countries making determined adjustment efforts; and (5) readiness to provide bridge financing as necessary from central banks and governments, on a case-by-case basis, in support of adjustment efforts.

Let me elaborate on each element in the strategy.

The first, and indeed central, element of the strategy is that debtor countries adopt comprehensive, credible and effective programs for strengthening their balance of payments and stabilizing their economies. Generally, these are policies that reduce internal imbalances commonly associated with excessive government spending and price controls, that encourage investment and that make domestic production more competitive in international markets. Although a few debtors have failed to make serious efforts to put into place a credible adjustment program, the overwhelming majority have, in fact, made substantial progress in adjustment efforts. Mexico is a good example of a country that has implemented a sound adjustment program, laying the basis for a restoration of stable economic growth.

The second element is that the industrial countries follow policies leading to sustainable, non-inflationary economic growth in the industrial world. At the same time, industrial countries must keep their markets open to exports from developing countries. While there have been, unfortunately, some protectionist steps, multilateral efforts are underway, with U.S. support, to roll back these measures and move forward once again toward more open markets. At the same time, recovery in the industrial world, led by the strong U.S. economy, is clearly underway. This recovery already has had a positive impact on the exports of many major debtors, which is reflected in our own trade deficit.

The third element in our strategy is a strengthening of the IMF, the key international institution for supporting adjustment in debtor countries. This is especially important because of the catalytic role the IMF plays in helping debtor countries formulate adjustment programs that will encourage creditors to provide more financial support. The IMF has, in fact, been considerably strengthened over the past year, both by increases in its resources and changes in its lending policies. On the resource side, the IMF's position was enhanced by the increase in quotas, the enlargement and modification of the General Arrangements to Borrow (GAB), and recently concluded borrowing arrangements. These have all reinforced the Fund's capacity to provide temporary balance of payments financing in support of adjustment efforts. On the lending side, changes agreed last fall in the IMF's access policy represent an important step toward ensuring that the IMF lives within its means.

The fourth element is continued commercial bank lending for countries making determined adjustment efforts. Commercial banks generally have shown a willingness not only to continue lending to these countries, but to do so on better terms in cases where the debtor is making clear progress in its adjustment program. Both Mexico and Brazil are examples of countries which have managed to obtain additional lending on better terms in the light of improved economic policies and performance.

The fifth element concerns the readiness of creditor governments to provide bridge financing on a selective basis when appropriate. The U.S. and other creditor governments have provided short-term bridge financing on a number of occasions to debtors in support of adjustment efforts. I will elaborate on this later in my testimony when discussing the use of the Exchange Stabilization Fund (ESF).

Implicit in the debt strategy is the idea of addressing the problems of each debtor country individually. A case-by-case approach is necessary because the causes of debt problems vary from country to country, the policy reforms required are different, relative exposures of creditor groups are different, and the political interests of creditor governments are different.

This debt strategy has provided the framework for successful efforts over the last two years to prevent debt problems from undermining world economic growth and the stability of the international monetary system, while starting many debtors on the road to economic recovery. We believe this strategy continues to be a viable and pragmatic basis for dealing with the problems of individual debtors.

Mr. Chairman, you and other Committee members have expressed concern over the possibility of further increases in interest rates and its implications for the major debtors. Debt service payments are, indeed, sensitive to general interest rate levels, as they are to spreads and fees over these base levels. Each percentage point of interest rate increase, for example, results in additional net annual payments by non-OPEC LDCs of about $2 billion, or around 5 percent of their aggregate current account deficit in 1983.

Our debt strategy recognizes the importance of interest rates by focusing on the need for stable, non-inflationary growth in the industrial countries. As noted above, major progress has been made on this front in the last three years. Led by the strong U.S. recovery, economic expansion in the industrial world is clearly established. After a decline of 0.1 percent in the level of economic activity in industrial countries in 1982, we now foresee a rise on the order of 4 percent in 1984. At the same time, inflation has fallen among the industrial countries from a level of over 10 percent in 1981 to an expected level of 5 percent in 1984.

These developments have provided an environment for a decline in nominal interest rates, and rates as measured by the London Interbank Offer Rate (LIBOR) have indeed fallen, from an average level of nearly 17 percent in 1981 to under 10 percent in 1983. Not only did this significantly ease the debt service burden through the reduction in interest payments, but the world economic recovery has directly enhanced the capacity of LDCs to service their debt, with each percentage point of growth in the industrial world stimulating additional LDC exports by approximately $5-6 billion.

The recent upward movement in interest rates is, of course, unwelcome, not only from an international perspective but from a domestic point of view as well. I would point out that the increase over 1983 levels has been partially offset by a tendency of narrowing spreads over the base rates, as countries improve their creditworthiness through better economic performance under IMF-supported adjustment programs. For example, taking into account the smaller fees, the spread on Mexico's 1984 new money package is 1.57 percent, compared to 2.46 percent in 1983.

This does not, however, lessen the importance of reestablishing the downward trend in interest rates. We believe that recent interest rate developments represent only a temporary divergence from the downward trend of the last few years. They reflect in part some continued inflationary expectations in the marketplace. With continued determination on the part of the United States and other countries to pursue a policy of stable, non-inflationary growth, we believe these expectations can be eliminated and that the present rise will stabilize well short of previous peaks and resume a downward movement.

ARGENTINA'S ECONOMIC AND FINANCIAL SITUATION

The Argentine package is only the most recent example of our debt strategy in action. Let me now turn to that case, discussing the circumstances leading up to March 30.

The inauguration of President Raul Alfonsin on December 10, 1983, was hailed worldwide as the beginning of a new era for Argentina and a victory for democratic forces in Latin America. The United States welcomed this development and offered its support.

But the Alfonsin Administration faced severe economic problems when it took office. Inflation was running at 435 percent and the level of economic activity was at its lowest point since 1974. Large external debts raised interest payments in 1983 to an amount equivalent to more than 60 percent of the roughly $8 billion of export earnings in that year. External arrears of all kinds -- on imports, interest and other payments -- were approaching $3 billion at the end of 1983. Although the preceding government had signed a standby agreement with the IMF in January 1983, and initially had made some progress under this agreement, by the end of the year the situation had deteriorated.

The new government began to work on the country's economic problems immediately upon taking office. As with any new administration, it has needed some time to position itself for a successful effort. But unlike many new governments, Argentina has not had accurate data on which to build an economic program. Thus one of the first orders of business has been to develop reliable economic data which could provide the basis for policy formulation. While this process has been under way, the government has, of course, begun focusing on the major policy areas, such as the budget, but work has been delayed by the data problem.

In January 1984, the government began discussions with the IMF on a new adjustment program. The objective of such a program would be to restore the conditions for economic growth and price stability in Argentina, and to give foreign lenders confidence in the direction of Argentina's economic policy. In order for this program to be properly formulated, a considerable amount of time-consuming technical work, including dealing with the data problems referred to above, has been required. This was a major focus of the discussions in the January-March period.

A major impetus to these discussions has been the severe debt service difficulties encountered by Argentina as the third largest LDC net borrower. The Government of Argentina estimated its total external debt at the end of 1982 at $40.7 billion, not including arrears of $2.9 billion at that time. Foreign commercial banks held $25.7 billion of Argentina's debt at the end of 1982, according to estimates of the Bank for International Settlements (BIS). About one-third of that amount is owed to U.S. banks and two-thirds to banks from other countries.

The new government has said from the very beginning that it would honor its foreign obligations. To do so, however, it felt it needed to reschedule its outstanding debt, particularly with the private banks. In an effort to reschedule this debt, and to obtain new funds, Argentine representatives have also been talking to foreign banks since January 1984. While some progress appears to have been made, it is our understanding that difficulties have arisen in these discussions, and that many issues remain unresolved.

In the meantime, substantial amounts of interest were paid to foreign creditors. But given Argentina's meager holdings of official liquid reserves, as well as the need to maintain a flow of essential imports, its interest payments in the December-March period were insufficient to prevent a sizable amount of interest arrears.

By the time of the annual meetings of the Inter-American Development Bank, held in Punta del Este, Uruguay, on March 25-27, the consensus among bankers was that there was little chance for a rescheduling agreement before March 31 -- the date on which banks would have had to place Argentine loans on a nonaccrual basis. It was clear at those meetings, which I attended with Treasury Deputy Secretary McNamar, that U.S. banks had already accepted the need to carry Argentine loans on a cash basis and reverse previously accrued interest.

It is important to understand that the U.S. decision to participate in the March 30 package was not prompted by a concern over the financial position of U.S. commercial banks. We made the judgment early in March that the earnings penalties which would be suffered by U.S. banks would be sustainable without a threat to the system. Rather, we feared that Argentina's failure to pay interest arrears by March 31 could pose a significant threat to its creditworthiness and its ability to restore a sound economy. Applicable federal guidelines would have required commercial banks to place Argentine loans on which interest payments were more than 90 days in arrears on March 31 on a nonaccrual basis. As a result, we believed that Argentina's creditors would have viewed the new government in a much less favorable light, and that commercial banks as a group would have been less willing over time to provide new financing for Argentina even if an adjustment program were agreed with the IMF.

In addition, we discovered that several Latin American countries, which had begun to assess the implications of a downward classification of Argentine debt, were themselves concerned about the adverse effect of such a classification on their own financing prospects with the banks.

It was in this context that Mexican Finance Minister, Silva Herzog, came up with a proposal to support Argentina's adjustment efforts by enlisting the support of other Latin governments, an idea he put first to the Argentines before asking the United States to participate as a lender. As the package was ultimately put together, it included the following elements:

-- Mexico, Venezuela, Brazil and Colombia, all debtor countries themselves, collectively loaned Argentina $300 million on a short-term basis;

-- Eleven commercial banks on the International Advisory Committee for Argentina provided another $100 million;

-- Argentina used $100 million of its own reserves;

-- The U.S. committed itself to lend $300 million to Argentina after Argentina reaches agreement with the IMF on an adjustment program; and

-- All parts of the package were conditioned on receipt of a positive progress report from the Managing Director of the IMF on the discussions proceeding that week between the IMF and Argentina concerning a new adjustment program. This was forthcoming late on Friday night, March 30.

The $500 million made available under this arrangement was used by Argentina to reduce its interest arrears to the commercial banks, thereby avoiding major potential adverse effects on its creditworthiness.

The U.S. Government has not yet lent any money to Argentina, and will do so only after agreement is reached with the IMF on Argentina's new economic program. The $300 million we are committed to lend at such time agreement is reached will be used by Argentina to repay the four Latin American Governments. We, in turn, will be repaid when Argentina makes its initial drawings on the IMF under the new standby arrangement.

In our view that package was an imaginative response to a difficult problem. It demonstrated our common interests in the handling of the region's debt problem, strengthening our ties not only with Argentina's new government, but with all of Latin America. We believe it is an important example of creditor-debtor cooperation, centered around a country's efforts to put into place an adjustment program, and that it also demonstrates the flexibility of our debt strategy. However, let me make clear that the creditor governments have done their part -- it is now up to Argentina to design and implement promptly a sound adjustment program which can obtain the support of the IMF and the international financial community.

Before addressing the particular role of the ESF, I would like to clear up some misconceptions which have arisen in connection with this package:

First, this was not a "bank bailout" by American taxpayers. No taxpayer money will be used to pay off the banks. We were motivated by our desire to support the new democratic government of Argentina and to help ensure continued and effective functioning of the international monetary system, not to help U.S. banks avoid reporting earning losses for the first quarter of 1984. As I noted earlier, banks provided $100 million in this operation, and are expected to increase their lending and to reschedule existing debts when Argentine agreement is reached with the IMF.

Second, the intervention of Mexico, Brazil, Venezuela, and Colombia in support of Argentina seems to be viewed by some observers as the beginning of a debtors' cartel which could fundamentally alter the terms of debtor-creditor relationships. We view their cooperative actions in a more positive light, reflecting a recognition that restoring and preserving international creditworthiness through sound policies is key to the economic prosperity of all Latin America. We decided to associate ourselves with this effort, in part to foster the constructive nature of this joint approach by Latin American debtors. Mexico approached Argentina and the other Latin debtors with their initial proposal before approaching the United States. We were unwilling to participate in the proposed arrangement unless a means was found to provide us with the reasonably assured source of repayment in the short-term. This was eventually accomplished by virtue of the arrangement under which the U.S. would not provide financing until agreement was reached between Argentina and the IMF on a stabilization program.

Thus we were able to incorporate use of the ESF without excessive risk while at the same time avoiding the risks of disassociating the United States from this important Latin American initiative for Argentina.

A third misunderstanding concerns the role of the Federal Reserve System in this operation. The Federal Reserve has not and will not lend any money to Argentina under the March 30 arrangement. The Federal Reserve participated solely as agent, receiving the money of the various lenders and transferring it at the appropriate time to the agent bank responsible for the distribution of the interest payments. No taxpayer money was involved; the Federal Reserve did not guarantee the package. President Solomon of the Federal Reserve Bank of New York will discuss the Federal Reserve's role in more detail.

Fourth, some observers have argued that the agreement undermines the role of the IMF. This is not the case. Based as it was on the progress report from the Managing Director, the agreement furthered the efforts of Argentina to formulate a new economic adjustment program and improved the prospects for successfully reaching agreement with the IMF.

Use of ESF Resources

Now I will turn to your question concerning use of the ESF in the Argentine financing package. As you are aware, the ESF was established in 1934 to provide the Secretary of the Treasury with funds to conduct international monetary transactions to "stabilize the exchange value of the dollar."

In the post-war establishment of the IMF, the Congress decided that, while the IMF would provide a multilateral framework for promoting international monetary stability, the ESF would also continue to be needed by the United States for stabilization operations. When the IMF Articles were amended in 1978 to reflect a fundamental change in the international monetary system from fixed to flexible exchange rates, an amendment of the statutory basis for ESF operations also became effective at that time. This was necessary in order to conform the purpose of the ESF to the changes in the international monetary system embodied in the amended IMF Articles. The IMF Articles no longer required countries to maintain fixed par values for their currencies, but to collaborate with the IMF and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. The Congress thus authorized the Secretary to use ESF resources to conduct operations "consistent with U.S. obligations in the IMF regarding orderly exchange arrangements and a stable system of exchange rates."

Operationally, the ESF conducts transactions either directly in the foreign exchange market or indirectly through providing short-term financing to foreign monetary authorities. With respect to direct operations, U.S. policy is to intervene in the foreign exchange market only to counter disorderly conditions.

In addition, throughout its fifty-year history, ESF resources have been used to finance short-term currency swaps with developed as well as less developed countries, including the United Kingdom, France, Portugal, and a number of Latin American countries. Thus, the ESF arrangement with Argentina follows short-term arrangements with a number of other countries over the years.

In order to emphasize the intended short-term, revolving nature of ESF financing -- and the assurance that primary reliance is placed on conditional, temporary balance-of-payments financing provided by the IMF -- an amendment to the ESF statute was enacted in 1977 specifying that "a loan or credit to a foreign entity or government of a foreign country may be made for more than 6 months in any 12-month period only if the President gives Congress a written statement that unique or emergency circumstances require the loan or credit be for more than 6 months."

Treasury policy has been fully consistent with that requirement. ESF financing is provided only for short periods, and under circumstances which provide a reasonably assured source of repayment. Financing is considered on a case-by-case basis, based on a demonstrated need for liquidity and evidence of adjustment efforts in cooperation with the IMF. To conserve the ESF's limited resources, to share its financing burdens, and to demonstrate international concern and broad participation, the Treasury seeks, in appropriate cases, to obtain the participation of other countries in these bridge financing arrangements.

The ESF financing for Argentina is fully in compliance with the statutory provisions governing the ESF, its legislative history, and the policies which I have discussed regarding the use of the ESF. Argentina also illustrates the necessity for the case-by-case approach to dealing with the problems of international indebtedness. Argentina faced an extraordinary need for short-term liquidity at a time when it was working to formulate an economic adjustment program in cooperation with the IMF. As discussed earlier, ESF financing clearly supports the IMF in its role of providing conditional, temporary balance of payments financing. Reasonable assurance of repayment in the short-term is provided under the terms of the March 30 package. The availability of ESF financing played the critical part in developing the overall financing package, assuring the participation of the four Latin American Governments and the commercial bank group.

CURRENT STATUS

Before concluding, Mr. Chairman, let me provide you with an update on the Argentine package. Since March 30, Argentina has been involved in intensive work with the International Monetary Fund to reach agreement on a common analytical base for an adjustment program, resolving in the process a range of technical questions necessary to lay the basis for an IMF agreement. Major policy issues have also been under discussion. Progress has been made, but no final agreement has yet been reached. There have not, however, been productive discussions with the commercial banks so far.

We have consulted with Argentina on their intentions with respect to the IMF and have received assurances that progress has been made. We also discussed with Mexico the possibility of the Latin American countries extending their commitments for an additional period. In the event, the Latin American governments decided to extend their commitments for 30 days, and we agreed to extend our swap commitment for an additional month, in the expectation that Argentina will sign an agreement with the IMF before May 31. The basic provisions of our original agreement remain intact; that is, that no ESF funds will be provided until agreement on an economic adjustment program is reached between Argentina and the IMF.

CONCLUSION

Mr. Chairman, my testimony makes clear that the U.S. participation in the recent Argentine financing package is fully consistent with our debt strategy and the law and policies governing the ESF. This package is unique, and was assembled in the best tradition of hemispheric cooperation. Its final goals have not yet been fully achieved, but I am confident that they will be achieved as the new government in Argentina works toward developing a stable economic climate in which to build enduring democratic institutions.

Senator HECHT. Thank you, Mr. Secretary.

Mr. Anthony Solomon, President, Federal Reserve Bank of New York.

STATEMENT OF ANTHONY M. SOLOMON, PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK

[The complete statement follows:]

Mr. Chairman and Members of the Subcommittee:

I welcome this opportunity to testify, on behalf of the Federal Reserve System, about the recently announced financial package to help Argentina meet interest payments on its bank debt. I think these hearings can be helpful in setting the record straight and clearing up any misunderstandings which may have arisen about the Fedeeral Reserve's role in these arrangements.

Assistant Secretary Mulford has outlined the main features of the package, and has described the events leading up to the agreement on that package. I will comment on the role of the Federal Reserve, and respond to some questions which have been raised about the significance of this agreement.

Let me make clear at the outset that there was no Federal Reserve money and no Federal Reserve guarantee in any way involved in the arrangement. The Federal Reserve participated as agent, and only as agent, through the Federal Reserve Bank of New York, at the request of the other parties to the agreement.

In this capacity, the Federal Reserve had no financial interest in the transaction, but received and held the money that was being provided by the other parties, and, at the proper moment, transferred that money to an agent bank that made the payments to meet Argentina's overdue interest obligations.

The New York Federal Reserve routinely acts as an intermediary in transactions at the request of other central banks, just as they sometimes act for us, and in that sense this transaction was not extraordinary. In the normal course of business we regularly receive and hold funds for other central banks, generally funds that represent these nations' dollar reserves. At the owners' instruction, we invest these funds, largely in U.S. Government securities, or disburse them.

As agent for the Argentine financing package, the New York Federal Reserve set up an escrow account on its books. On March 30 we received deposits of $500 million into the escrow account, representing $100 million from the Government of Argentina, $100 million from the eleven commercial banks on the Working Committee for Argentina, and $300 million from the monetary authorities of Mexico, Venezuela, Brazil and Colombia. We also received from the Managing Director of the International Monetary Fund a progress report stating that constructive discussions had taken place with the Argentine Government on Argentina's recent economic policies and the main elements of a program of economic stabilization which would provide the basis for IMF support. With the full $500 million on deposit and with this progress report, we transferred the $500 million to the agent bank in New York, which in turn disbursed funds to banks around the world to meet Argentina's overdue interest obligations.

There was one additional way in which the New York Fed played an operational role. As part of the arrangement, the Argentine Government agreed that it would repay the eleven commercial banks in the lending group $100 million upon the completion of pending lending arrangements with a large syndicate of banks. If those lending arrangements are not completed by June 30, the Argentine Government has agreed to repay the eleven banks from Argentine deposits held at the New York Reserve Bank. The Argentineans transmitted instructions to the New York Fed to give effect to that understanding. We in turn informed the eleven banks that procedures reflecting Argentine obligations to repay the $100 million loan had been completed. In general, in the course of the discussions leading up to the agreement and the Federal Reserve's operational role, we were, naturally, in close touch with Treasury officials, some commercial banks, and interested foreign central banks.

It should be clear that, by participating in this arrangement, the New York Federal Reserve has not backed or guaranteed payment to the commercial banks with its own funds, and no party has any claim against the Federal Reserve. I repeat this because some of the press reports may have conveyed a different impression.

Mr. Chairman, your letter inviting the Federal Reserve to testify asked that we comment on its significance with respect to several matters, including the broader implications of this loan package for future developments in the Latin American debt crisis and for the U.S. banks.

My own assessment is that the agreement on the financial package constituted a very positive and constructive move, of benefit to all the parties. The U.S. participation is consistent with earlier actions taken, for example, with respect to Mexico and Brazil supporting their adoption of IMF adjustment programs. I think this action has substantially improved the prospects for working out Argentina's debt problem and domestic economic difficulties on a satisfactory basis. As a first step, that process inevitably requires a rescheduling of maturing debt obligations along with a new money package, both linked directly to a new IMF-supported adjustment program. The short-term financial package which we are discussing today provided both valuable time and positive momentum for that approach. But the package itself does not assure a satisfactory resolution of the Argentine problem, much less resolve the broader debt issues of Latin America as a whole.

Perhaps it would help if I sketched in a bit of the background of Argentina's debt problem. Argentina's difficulties in servicing its debt began to emerge even before the time of the Falklands war, when its economy was experiencing large capital outflows, domestic recession, and rapidly accelerating inflation. Early in 1983, agreement was reached on an IMF-supported adjustment program, and progress was made on clearing up arrears and rescheduling the debt. But later in 1983, during the final months of the military government, wages policy slipped badly, inflation rates soared, and interest arrears on the external debt began once again to build up rapidly.

The newly elected Alfonsin government set forth the main themes of its approach to the debt problem soon after it took office in December. It made clear that it wanted to reach agreement with the IMF on a new adjustment program -- while emphasizing its intention to make the adjustments its economy needed largely through major reductions in government expenditure and in the size of the budget deficit, but without further recession or cuts in real wages. The new government also stated that it wanted to work out rescheduling agreements with banks and other creditors -- but warned that it would press for better terms than had been negotiated by the previous military government.

While discussions continued with the IMF and with the creditor banks, Argentina's interest arrears accumulated, particularly to bank creditors. For U.S. banks, interest in arrears for more than 90 days has particular significance. Under the reporting requirements used by our Federal bank supervisory agencies, as well as those used in certain states including New York, banks generally can continue to accrue interest as income once it is past due and unpaid for only up to 90 days. Thus, once interest is unpaid for *more than 90 days*, under current practice, U.S. banks would generally have to stop reporting that interest as income in quarterly reports filed with bank supervisors. They would, in most cases, also reverse previous accruals and take that unpaid interest out of income or reserves. Since U.S. banks must publish their balance sheets on a quarterly basis -- March 31, June 30, etc. -- the March 31 date was significant. Let me state that this was particularly if not uniquely significant for U.S. banks, given our system of comprehensive public *quarterly* reporting, which has no parallel in the other major industrial countries.

I think that most U.S. banks had more or less assumed that Argentina's interest arrears in excess of 90 days would *not* be cleared up by March 31. They had accepted the fact that accruals of interest income on many Argentine public sector loans would stop, and that prior accruals would be reversed as of that date. Nonetheless, I think that there was genuine concern among all parties, including Argentina as well as others, that such a development entailed substantial risks. Clearly there would have been an appearance that the situation was eroding, and that positions might harden on all sides. Should that have developed, there were several concerns. For one, the domestic financial situation in Argentina could have deteriorated further, from capital outflows and other financial pressures. Also, the prospects of rescheduling Argentina's debt on acceptable terms, and in the framework of a new IMF program, would diminish, with possible adverse spillover effects for the debt problem more broadly.

Argentina would have been the first major Latin American borrower in recent times to shift into nonaccrual status on its sovereign debt. It is not clear what might have been the reaction, either of creditors -- who might be troubled about the precedent for other debt situations -- or Argentina as well as other debtors. Certainly it would have been much more difficult to arrange new bank financing for Argentina in the future -- even with an IMF program -- if Argentine loans had shifted to nonaccrual status. And it might have made refinancings more difficult for other sovereign debtors as well. It was against this background that the Mexicans took the initiative to propose a new financial package. Both the Argentineans and the creditors quickly saw the advantages of that approach.

The Argentine package in no way represented a "bank bailout" with taxpapers money. U.S. Government financing, through the Treasury's Exchange Stabilization Fund, is to be available, on a temporary basis, for one essential purpose--to encourage agreement between Argentina and the IMF on an adjustment program. This is in close conformance with U.S. law--which calls for the ESF to be used to support U.S. objectives in the IMF--and with past practice, in that similar bridging loans have played an essential role in the adjustment efforts, for example, of Mexico and Brazil. It is very likely that a new IMF-supported adjustment program, which this package is designed to encourage, will call for additional financing from the commercial banks. Moreover, I am certain that within the framework of an IMF program, every effort will be made, in accordance with that same U.S. legislative provision, to arrange a rescheduling of debt that is "consistent with safe and sound banking practices and the [borrowing] country's ability to pay."

Your letter asked whether current growth and interest rate projections provide reason for optimism that the debt crisis is soluble. The outlook for recovery and expansion in the industrial countries is encouraging, with growth at about 3-1/2 percent this year and next--which means that less developed countries' exports could grow 5-7 percent and commodity prices should continue to move up. This would certainly help debtors, but not enough to resolve their problems.

Interest rate increases are of course particularly burdensome to heavily indebted nations--a 1 percent rise worldwide adds $3-1/2 billion or more to debt servicing costs of non-oil developing countries after a full year. That figure lends stark emphasis to the need for urgent and decisive action on our budget deficit, certainly the single most effective means of countering the problem of high interest costs. In addition, those involved in debt negotiations might want to consider techniques of limiting, by some kind of cap on interest rates, the potential problems for the successful implementation of IMF-supported adjustment programs which might result were there further increases in interest rates.

I do not think that failure to arrange the Argentine package, with resulting nonpayment of interest, would, by itself, have had a significant adverse impact on the safety and soundness of the U.S. banking system. I have attached to my statement a table which summarizes the information presented publicly by several of the largest U.S. banks in their first quarter financial statements regarding the effect of the package on their quarterly earnings. As those data certainly suggest, the soundness of the banking system was not endangered. That's not to suggest that in some cases the potential effect wasn't significant, particularly if arrears continued to build up for an extended period; but in all cases the immediate impact was, in my opinion, quite manageable. Nor do I think concern over the immediate impact on the stability of financial markets was the most important aspect of this matter -- there is nothing to suggest that the prospect of nonpayment wasn't largely if not entirely discounted by financial markets. Rather, I think the Argentine package was prompted by a shared objective to improve the prospects for agreement on an IMF adjustment program, and as a basis for a more workable and acceptable rescheduling of the Argentine debt. Let me cite some key, closely related advantages.

First, it demonstrated to the new Argentine Government both that there was a willingness on all sides to help deal with Argentina's severe debt and economic problems and that there was a strong international interest -- including among other Latin American borrowers -- in seeing Argentina move promptly to formulate an effective economic program and reach agreement with the IMF.

Second, it brought together five key Latin American governments -- Argentina and the four lending countries -- under the umbrella of a Latin American initiative, to cooperate in finding ways to meet their debt obligations. This should help defuse some of the North-South rhetoric on a problem that will require cooperation, not confrontation to resolve successfully.

Third, in my judgment, it brought Argentina and the IMF closer toward agreement on an adjustment program, and strengthened the incentives to reach final agreement on an IMF program in order that the Latin American creditor governments can be repaid promptly.

Some say the result was only to buy time. But the Argentine package does more -- not only is there now more time, there is also an improved environment for coming to grips with the outstanding issues between Argentina and the IMF, and between Argentina and the creditor banks. Yet, unquestionably there remain some formidable issues still to be negotiated.

Argentina is of course but one of a number of nations, in Latin America and elsewhere, that have encountered serious debt problems. These have to be viewed not as a single problem but as thirty or more individual problems, each with its own unique characteristics and within its own political and economic setting. Yet they do all have common features, and success -- or failure -- in one country, particularly a large one, can breed success -- or failure -- in others. Thus, in my judgment, if success can be achieved in dealing with the Argentine debt problem, that success will to some extent spill over and encourage success elsewhere. Similarly, demonstrated progress in dealing with other countries' debt problems will improve the environment for Argentina.

Attachment

Effect of Argentine Financing Package On Earnings of Major U.S. Multinational Bank Holding Companies 1/

($ in millions)

	Increase in Nonperforming Loans Had Interest Payments Not Been Made	Net Income As Reported 1st quarter 1984	Contribution of Interest on Argentine Loans to Reported Net Income: Amount	Percent
Bank of America	N.A.	$101.1	$4.0	4.0
Bank of Boston	$ 16.0	24.9	.9 (e)	3.6
Bankers Trust	N.A.	69.2	.9	1.3
Chemical	N.A.	81.3	3.1	3.8
Citicorp	128.0	223.0	5.6	2.5
Manufacturers	426.0	84.0	19.3	23.0
J.P. Morgan	301.0	146.0	12.3	8.4

(e) = estimate based on published pre-tax contribution of $1.8 million.

1/ Data are from published first quarter earnings reports.

Federal Reserve Bank of New York
May 2, 1984

Senator Mattingly. Thank you, Mr. Solomon.
Mr. Dennin.

STATEMENT OF JOSEPH F. DENNIN, ACTING ASSISTANT SECRETARY FOR INTERNATIONAL ECONOMIC POLICY, DEPARTMENT OF COMMERCE

Mr. Dennin. Thank you, Mr. Chairman. I apologize for being late. I was before the Senate Finance Committee just now.

[The complete statement follows:]

MR. CHAIRMAN, ON BEHALF OF THE INTERNATIONAL TRADE ADMINISTRATION OF THE DEPARTMENT OF COMMERCE LET ME BEGIN BY THANKING THE COMMITTEE FOR THE INVITATION TO TESTIFY ON A SUBJECT THAT MANY CONSIDER ONLY A FINANCIAL ISSUE. UNDER SECRETARY OLMER HAD HOPED TO BE ABLE TO TESTIFY BUT HE IS RETURNING THIS AFTERNOON FROM PARTICIPATING IN PRESIDENT REAGAN'S TRIP TO CHINA.

THE COMMERCE DEPARTMENT WAS NOT DIRECTLY INVOLVED IN PUTTING TOGETHER THE SHORT-TERM FINANCING PACKAGE IN SUPPORT OF ARGENTINA'S ADJUSTMENT EFFORT. HOWEVER, IT CERTAINLY SEEMS THAT THIS WAS THE BEST WAY TO ALLOW MORE TIME FOR THE GOVERNMENT OF ARGENTINA TO WORK OUT A COMPLEX NEGOTIATED AGREEMENT WITH THE INTERNATIONAL MONETARY FUND. THE ARRANGEMENT HAS ALSO SUSTAINED A FAVORABLE FINANCIAL ENVIRONMENT IN WHICH ARGENTINA AND OTHER COUNTRIES IN LATIN AMERICA COULD CONTINUE THEIR DIFFICULT BUT NECESSARY ADJUSTMENT PROGRAMS. YOU HAVE HEARD ASSISTANT SECRETARY MULFORD DESCRIBE THE TERMS AND CONDITIONS OF THE SWAP AGREEMENT THAT HAS BEEN WORKED OUT WITH ARGENTINA. THE COMMERCE DEPARTMENT FULLY CONCURS WITH TREASURY THAT OUR OVERRIDING CONCERN WAS NOT WITH THE QUARTERLY PROFIT PICTURE OF THE U.S. BANKS BUT WITH ARGENTINA'S CREDITWORTHINESS AND ITS PROSPECTS FOR A SUCCESSFUL ADJUSTMENT. HERE WAS A FRIENDLY AND STRUGGLING NEW DEMOCRATIC ADMINISTRATION THAT HAD INHERITED A SEVERE ECONOMIC SITUATION, AND WHOSE PRESIDENT, RAUL ALFONSIN, HAD AFFIRMED ARGENTINA'S INTENTION TO ADJUST ITS ECONOMY AND HONOR ITS DEBTS. AS TREASURY NOTED, THE IMF REPORTED PROGRESS IN DISCUSSIONS AIMED AT REACHING AGREEMENT ON A LETTER OF INTENT IN SUPPORT OF A NEW ADJUSTMENT PROGRAM.

THIS MADE IT LOGICAL FOR THE UNITED STATES TO LEND ITS CONTINGENT COMMITMENT TO THE FINANCING PACKAGE.

TO BETTER UNDERSTAND WHY THE DEPARTMENT OF COMMERCE THINKS THIS WAS AN IMPORTANT STEP, LET ME BRIEFLY ILLUSTRATE WHAT HAS HAPPENED TO THE U.S. TRADE PICTURE IN LATIN AMERICA OVER THE LAST TWO YEARS:

U.S. EXPORTS TO LATIN AMERICA DROPPED BY MORE THAN $16 BILLION BETWEEN 1981 AND 1983. USING A RULE OF THUMB OF 25,000 U.S. JOBS PER $1 BILLION OF EXPORTS, IT IS CLEAR THAT THE CUMULATIVE LOSS OF 400,000 JOBS HAS HAD A SEVERE IMPACT HERE AT HOME. THESE EXPORT LOSSES ARE EVEN MORE SIGNIFICANT BEARING IN MIND THAT BEFORE THE DEBT CRISIS, LATIN AMERICA WAS ONE OF THE FASTEST GROWING MARKETS IN THE WORLD FOR U.S. EXPORTS.

OUR EXPORTS TO ARGENTINA HAVE FOLLOWED THIS REGIONAL PATTERN, DECLINING 56 PERCENT, FROM $2.1 BILLION IN 1981 TO UNDER $1 BILLION IN 1983. SIGNIFICANTLY, THIS DECLINE HAS OCCURRED IN NEARLY ALL MAJOR PRODUCT CATEGORIES, WITH METALS, MACHINERY AND TRANSPORTATION EQUIPMENT SUFFERING THE LARGEST LOSSES. OUR EXPORT DECLINE CONTINUED INTO THE EARLY MONTHS OF THIS YEAR, AND, IF ANYTHING, A LITTLE MORE RAPIDLY.

TO COPE WITH A RAPIDLY GROWING BALANCE OF PAYMENTS PROBLEM, THE COUNTRIES OF LATIN AMERICA, INCLUDING ARGENTINA, HAVE CUT BACK SHARPLY ON THEIR IMPORTS, AND THIS HAS INEVITABLY HAD ITS GREATEST IMPACT ON THE U.S., SINCE WE ARE THE LEADING SUPPLIER TO THE

REGION. THE PICTURE IS THE SAME IN NEARLY ALL THE COUNTRIES OF LATIN AMERICA -- DOMESTIC RECESSION, A SHORTAGE OF FOREIGN EXCHANGE, INCREASING IMPORT RESTRICTIONS, ATTEMPTS TO SWITCH FROM IMPORTS TO LOCALLY PRODUCED GOODS, AND IN MANY CASES A DRYING UP OF TRADE CREDITS. IT IS IMPORTANT TO REMEMBER THAT DURING THE EARLY MONTHS OF THE CRISES IN MEXICO IN 1982, AND IN BRAZIL LAST YEAR, THE SHARP CONTRACTION IN THEIR IMPORTS ONLY BEGAN TO EASE AFTER AN IMF PROGRAM WAS IMPLEMENTED AND FUNDS DISBURSED. THE MEXICAN AND BRAZILIAN EXAMPLES ILLUSTRATE WHAT ANOTHER LIQUIDITY CRISIS COULD DO TO THE ABILITY OF THE OTHER LATIN COUNTRIES TO MAINTAIN CREDITORS' CONFIDENCE IN THEIR TRADE OUTLOOK. WERE ANOTHER SHOCK TO GO THROUGH THE FINANCIAL MARKETS, THIS PROCESS OF CAREFULLY RESTORING CREDITORS' CONFIDENCE WOULD BE ERODED.

IN THE CASE OF ARGENTINA, THEY WERE ALREADY FACING DIFFICULTY IN MAINTAINING TRADE LINES. IN FACT, BESIDES THE INTEREST ARREARS, THEY WERE ALSO BUILDING SUBSTANTIAL ARREARS IN TRADE CREDITS (ALTHOUGH IT DOES APPEAR THAT THEY WERE PAYING SOME SUPPLIERS AND CLEARING SOME TRADE PAYMENTS IN ORDER TO MAINTAIN ESSENTIAL IMPORTS). IT WAS CLEAR THAT A BREAKDOWN IN NEGOTIATIONS BETWEEN ARGENTINA AND THE BANKS WOULD SEVERELY AFFECT ARGENTINA'S ABILITY TO FINANCE TRADE, AND WOULD FURTHER IMPEDE U.S. EXPORTS. IT IS REASONABLE TO ASK WHAT WOULD HAVE HAPPENED HAD ARGENTINA NOT MET ITS INTEREST PAYMENTS. JUST FROM A SHORT-TERM TRADE POINT OF VIEW, THE EXPERIENCE OF THE LAST TWO YEARS IN LATIN AMERICA, PARTICULARLY WITH RESPECT TO MEXICO AND BRAZIL, INDICATES THAT A SUBSTANTIAL AMOUNT OF U.S. TRADE WAS AT RISK.

MR. CHAIRMAN, THERE IS GOOD REASON FOR US TO BE CONCERNED ABOUT THESE DEVELOPMENTS AND NOT ONLY FOR THE SAKE OF OUR OWN EXPORTS. FOR EXAMPLE, MANY FINANCIALLY CONSTRAINED COUNTRIES HAVE BEEN SEEKING TO ESTABLISH ALTERNATE MECHANISMS OF TRADE, SUCH AS COUNTERTRADE, BARTER, CLEARING ARRANGEMENTS AND SOFT CURRENCY PAYMENTS, IN ORDER TO SAVE OR SECURE HARD CURRENCY AND ACQUIRE ESSENTIAL IMPORTS IN THE FACE OF DIMINISHED ACCESS TO FINANCING. WE THINK THESE TRADE DEVELOPMENTS ARE INEFFICIENT, AND CAN VIOLATE MOST-FAVORED-NATION PRINCIPLES AND DISTORT TRADE PATTERNS. FOR EXAMPLE, THERE IS AN INCREASING INTEREST BY LDCS IN USING BILATERAL CLEARING ARRANGEMENTS TO MANAGE TWO-WAY TRADE, AND SOME EVIDENCE OF INCREASING LDC-EAST BLOC COUNTERTRADE. THESE TRENDS HAVE DISTURBING IMPLICATIONS FOR THE TRADING SYSTEM.

THAT IS WHY IT IS SO IMPORTANT THAT TRADITIONAL FINANCING MECHANISMS REMAIN OPEN AND AVAILABLE TO FINANCE NECESSARY IMPORTS, CONSISTENT WITH IMF ADJUSTMENT PROGRAMS.

IN ORDER TO KEEP THESE LINES OPEN, IT IS IMPORTANT TO PREVENT A BREAKDOWN IN THE ADJUSTMENT PROCESS AND SMOOTH THE FINANCING OF THIS ADJUSTMENT. A BREAKDOWN IN ARGENTINA FINANCING OR IN THE IMF/BANK NEGOTIATIONS, NO MATTER HOW SHORT, WOULD SEND ANOTHER SHOCK THROUGH THE FINANCIAL AND TRADING SYSTEMS. THE USE OF ESF FUNDS BRIDGED TO AN IMF PROGRAM IS ONE WAY TO PREVENT THESE SHOCKS AND IF PROPERLY USED, IS IN THE BEST INTEREST OF THE U.S. AS WELL AS THE MULTILATERAL TRADING SYSTEM.

THE SIGNING OF AN IMF AGREEMENT BY ARGENTINA IS NOT LIKELY TO END ITS TRADE AND FINANCIAL PROBLEMS. THE SAME GOES FOR OTHER MAJOR LATIN AMERICAN COUNTRIES. THEY WILL PROBABLY FACE FINANCIAL CONSTRAINTS AND TRADE ADJUSTMENTS FOR MANY YEARS TO COME. HOW LONG DEPENDS PRIMARILY ON CONTINUED ECONOMIC AND POLITICAL DISCIPLINE ON THE PART OF DEBTOR COUNTRIES, SUSTAINED ECONOMIC RECOVERY AND OPEN MARKETS IN DEVELOPED COUNTRIES, CONTINUED NET NEW LENDING BY BANKS, AND USE OF OFFICIAL RESOURCES WHEN NECESSARY. AS LONG AS THESE ADJUSTMENTS ARE REQUIRED, INTERNATIONAL TRADE, INVESTMENT AND TRADE FINANCE WILL BE FACED WITH ADDITIONAL PRESSURES TO ADAPT. OUR OBJECTIVE IS TO ENSURE THAT THESE PRESSURES DO NOT CAUSE FURTHER REDUCTIONS OR DISTORTIONS IN TRADE OR TRADING MECHANISMS AND THAT WE RETURN AS QUICKLY AS POSSIBLE TO A MORE NORMAL ENVIRONMENT FOR TRADE AND TRADE FINANCE.

MR. CHAIRMAN, THERE ARE SOME HOPEFUL SIGNS THAT WE NEED TO KEEP IN MIND WHEN ASSESSING THE OUTLOOK FOR ARGENTINA AND THE REST OF LATIN AMERICA. THE GREAT MAJORITY OF THESE COUNTRIES REALLY ARE DEALING WITH THE NEED FOR ADJUSTMENT, AT CONSIDERABLE POLITICAL AND SOCIAL COST, AND THE BENEFITS ARE BEGINNING TO SHOW. THE ECONOMIC PICTURE IN COUNTRIES LIKE MEXICO, CHILE AND NOW BRAZIL IS BRIGHTER THAN IT WAS JUST A FEW MONTHS AGO. THE SHARP DECLINE IN U.S. EXPORTS TO THESE COUNTRIES APPEARS TO BE LEVELING OFF. THE GLOBAL EXPORTS OF THE MAJOR LATIN AMERICAN COUNTRIES ARE INCREASING, PARTICULARLY TO THE U.S. BUT ALSO, IT NOW APPEARS, TO WESTERN EUROPE AS ECONOMIC RECOVERY THERE GETS UNDERWAY. THE

PRODUCTIVE SECTOR IN LATIN AMERICA IS SHOWING SOME SIGNS OF NEW VIGOR. THESE ARE WELCOME SIGNS FOR U.S. EXPORTERS AND U.S. COMPANIES ALIKE.

CERTAINLY, A RESTORATION OF VIBRANT ECONOMIES IN LATIN AMERICA IS IN OUR OWN BEST INTEREST. MEANWHILE EFFORTS, BOTH AT THE GOVERNMENT LEVEL AND IN THE PRIVATE SECTOR, ARE UNDERWAY TO FIND LONGER-TERM SOLUTIONS TO THE DEBT PROBLEM, INCLUDING MECHANISMS FOR INSULATING TRADE CREDITS FROM THE DEBT RESCHEDULING. IN OUR VIEW, THERE IS NO SIMPLE, LONG-TERM SOLUTION. ALL THE PARTIES INVOLVED HAVE TO COLLABORATE IN EQUITABLY DISTRIBUTING THE HARDSHIP OF ADJUSTMENT -- GOVERNMENT, EXPORTERS, INVESTORS AND THE COMMERCIAL BANKS ALIKE. A STABLE FINANCIAL SYSTEM IS THE BASIC NEED. INTERNATIONAL TRADE IS VERY IMPORTANT TO US. IF FINANCE IS NOT AVAILABLE WE CANNOT TRADE. IF WE CANNOT TRADE, WE LOSE JOBS AND INCOME. THAT IS WHY THE ARGENTINA FINANCING PACKAGE IS IMPORTANT. WITH THIS PACKAGE, WHICH PRESENTS MINIMUM RISK TO THE U.S. TAXPAYER, WE ARE STRENGTHENING THE PROSPECTS FOR U.S. TRADE AND INVESTMENT IN LATIN AMERICA AT A CRUCIAL MOMENT.

ATTACHMENTS (3 CHARTS)

#220

Attachment 1

U.S. EXPORTS TO LATIN AMERICA
($ billion; f.a.s. value)

	1981	1982	1983	% Change '82 vs. '83
ARGENTINA	2.1	1.3	0.9	-27%
BRAZIL	3.7	3.4	2.5	-26%
CHILE	1.4	0.9	0.7	-21%
PERU	1.5	1.1	0.9	-18%
VENEZUELA	5.4	5.1	2.7	-47%
MEXICO	17.4	11.0	8.8	-20%
Subtotal	31.5	22.6	16.6	-27%
BOLIVIA	0.2	0.1	0.1	---
COLOMBIA	1.7	1.9	1.5	-18%
ECUADOR	0.9	0.8	0.6	-22%
PARAGUAY	0.1	0.1	---	-70%
URUGUAY	0.2	0.2	0.1	-50%
S. AMERICA	17.2	14.7	10.1	-31%
LATIN AMERICA	41.2	32.3	24.9	-23%

SOURCE: U.S. Department of Commerce

Attachment 2

U.S. TRADE WITH LATIN AMERICA
($ billion)

	1981			1982			1983		
	EXP	IMP	BAL	EXP	IMP	BAL	EXP	IMP	BAL
ARGENTINA	2.1	1.1	+1.0	1.3	1.1	+0.2	0.9	0.9	+ 0.1
BRAZIL	3.7	4.5	-0.5	3.4	4.3	-0.9	2.5	4.9	- 2.4
CHILE	1.4	0.5	+0.9	0.9	0.7	+0.2	0.7	0.9	- 0.2
PERU	1.4	1.1	+0.3	1.1	1.1	---	0.9	1.1	- 0.2
VENEZUELA	5.4	5.6	-0.2	5.1	4.8	+0.3	2.7	4.9	- 2.3
MEXICO	17.4	13.7	+3.6	11.0	15.5	-4.5	8.8	16.6	- 7.9
Subtotal	31.4	26.5	5.1	22.8	27.5	-4.7	16.6	29.3	-12.7
BOLIVIA	0.2	0.2	---	0.1	0.1	---	0.1	0.2	- 0.2
COLOMBIA	1.7	0.8	+ 0.9	1.9	0.8	+ 1.1	1.5	0.9	+ 0.6
ECUADOR	0.9	1.0	- 0.1	0.8	1.1	- 0.3	0.6	1.3	- 0.7
PARAGUAY	0.1	---	+ 0.1	0.1	---	+ 0.1	0.1	0.1	+ 0.1
URUGUAY	0.2	0.2	---	0.2	0.3	- 0.1	0.1	0.4	- 0.4
S. AMERICA	17.1	15.0	+ 2.4	14.9	14.3	+ 0.6	10.2	15.6	- 5.4
LATIN AMERICA	41.2	38.6	+ 2.6	32.3	37.6	- 5.3	24.9	41.4	-16.5
U.S. TRADE WITH REST OF WORLD	187.7	220.5	-32.8	174.8	204.7	-29.9	171.1	215.2	-44.1
U.S. TRADE WITH THE WORLD	228.9	259.1	-30.2	207.2	242.3	-35.1	196.0	256.6	-60.6

SOURCE: U.S. Department of Commerce

Attachment 3

GLOBAL TRADE OF SELECTED LATIN AMERICAN COUNTRIES
(U.S. $ billion)

EXPORTS (f.o.b.)

	1981	1982	% Change	1983	% Change
Argentina	9.1	7.6	-17%	7.8	+3%
Brazil	23.3	20.2	-13%	21.9	+9%
Chile	3.9	3.7	- 5%	3.9	+4%
Mexico	19.4	21.2	+ 9%	21.4	+1%
Peru	3.2	3.3	+ 1%	3.0	-8%
Venezuela	20.2	16.5	-18%	15.2	-8%
TOTAL	79.1	72.5	- 8%	73.2	+1%

IMPORTS (f.o.b.)

	1981	1982	% Change	1983	% Change
Argentina	9.4	5.3	-44%	4.5	-15%
Brazil	22.1	19.4	-12%	15.4	-21%
Chile*	6.4	3.5	-45%	2.8	-22%
Mexico	24.0	14.4	-40%	7.7	-47%
Peru	3.8	3.7	+ 2%	2.7	-27%
Venezuela	12.1	13.2	+ 9%	6.5	-51%
TOTAL	77.8	59.5	-24%	39.6	-37%

BALANCE OF TRADE

	1981	1982	1983
TOTAL	+1.3	+13.0	+33.6

Source: Latin American governments
Note: *imports c.i.f.

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THE POSSIBLE EFFECTS OF NONPAYMENT OF ARGENTINE INTEREST

Senator MATTINGLY. Thank you, Mr. Dennin.

Mr. Mulford, you said that the U.S. concern over the Argentine situation was not prompted by concern about the effect nonpayment may have had on U.S. banks. Can you explain this a little bit more fully? Because the fact that the arrangement was concluded in time for Argentina to meet its quarterly interest payment causes some questions about that statement.

Mr. MULFORD. Yes, I can, sir.

In March as I said in my testimony, we made the determination that the size of the earnings hit that the banks would take at the end of March if Argentina did not pay the interest arrears was manageable by the banks without a threat to the banks or to the banking system, but as we approached the end of the month we became increasingly concerned that perhaps the new administration in Argentina did not appreciate the effect of nonpayment of interest at the end of the month would have to its own creditworthiness.

Let me elaborate on that. If Argentina had not paid the interest due, this would have been regarded by foreign governments and banks all over the world as a very important event and it might have been interpreted as a highly confrontational stance. The banks would have taken the earnings penalty and shortly thereafter, in our judgment, there was a strong likelihood that bank regulators in the United States would take action to classify Argentina's loans substandard, which means that banks would have begun to reserve against these loans.

We think that this would have caused a considerable division of opinion and practice within the banking community in the United States and elsewhere, and—because some banks we think would have withdrawn and would have decided to get out of the Argentine lending business—it would have resulted in a narrowing of the bank market available to Argentina. This narrowing effect we thought would have prevailed into the future even if after March 31 Argentina had managed to design an adjustment program and obtain agreement with the IMF.

We have already stated that when that happens it will be necessary for the banks to enter into discussions to reschedule Argentine debt and also to put up new money, and we were fearful that Argentina didn't appreciate that its chances for obtaining sufficient finance in the future when it has restored its house would have been substantially changed.

We think the evidence that that was the correct view was supplied at the very end of the month, when it became apparent that Argentina was not going to convince the banks to make a short-term bridge loan and that it was faced with this situation. We think the correctness of our position was confirmed by the attitude of the other Latin American governments who also believed that this would be the effect, and they feared that there might be some spillover of such an event on their own ability to often finance in the future. And that is what motivated them to come forward with their proposal, that they should step up and make some short-term assistance available to Argentina.

Senator MATTINGLY. Let me just ask you a little more on that and ask you also, Mr. Solomon. You have already said that the banks were committed to taking a hit by not receiving the payment, but don't you think this would have forced the banks to realize that they were going to have to reduce the interest rates and stretch out the maturities? I think this sort of hit might have forced a change in their long-term attitudes.

Mr. MULFORD. Well, I think that certainly that event if it had taken place—indeed it still might take place at some time in the future under some circumstances—could have that effect on the thinking of some banks, but I think it's equally likely that the effect might be to cause banks to feel that they should withdraw entirely from lending to Latin American governments, and in this case Argentina. We all believe that it is very, very important in these adjustment programs, and reschedulings, and IMF standby arrangements that the countries that are entering into these arrangements keep open credit markets for themselves so they can obtain the additional funds required, which means the banks' exposure will grow to some extent.

Senator MATTINGLY. But in this case, though, why shouldn't they stretch out the maturity?

Mr. MULFORD. Well, the maturity structure of the bank package eventually negotiated here, which will take place when the IMF agreement is reached, is yet to be determined. That's a matter for negotiation between Argentina and the banks.

Senator MATTINGLY. But also it would be a recommendation of the United States, wouldn't it?

Mr. MULFORD. Well, our position at the Treasury has been that the terms that apply between the banks and the various countries are commercial matters that are up to the countries and the banks to establish, and we have tended not to intervene directly in that private market function.

Senator MATTINGLY. I think we did sort of intervene to try to achieve the package, didn't we?

Mr. MULFORD. We intervened in the sense that we provided time for the adjustment program to be further developed, but we have avoided intervening with the banks to direct them as to what the commercial terms of their loans should be.

Senator MATTINGLY. With all the expertise we've got in the United States, wouldn't it seem like it would be well worth it to make a recommendation to stretch out the maturities since they can't pay in the timespan you're talking about?

Mr. Solomon, do you have a comment on that?

Mr. SOLOMON. Well, banks take the view—and I think properly so—that the central problem is the IMF adjustment program and therefore they are perfectly prepared to negotiate the stretchout you're talking about when the IMF program is concluded. There had been a previous negotiation when Argentina early in 1983 had concluded an IMF program and then when the new Government came in, there was not only the absence of a new IMF program, but there was also a question of the terms.

In my opinion, and I have no doubt in my mind, Mr. Chairman, that the central point will be a successful reaching of the agreement with the IMF and that the banks will reach agreement with

Argentina I'm convinced on a rescheduling as well as new money. So I think that it is not the banks that are refusing to do it; it is that they are waiting while they're having preliminary discussion—they are waiting to see whether there is an adjustment program that will provide a sustaining growth basis for Argentina and I wouldn't think there's any question of their readiness to reach a reasonable agreement with Argentina.

PROGRESS BEING MADE BETWEEN IMF AND ARGENTINA

Senator **Mattingly**. What progress has been made between the IMF and Argentina at this time, do you know?

Mr. **Solomon**. Well, as Secretary Mulford said, and I think the Treasury is closer to it, but our information is that continuing progress is being made and I believe there is a good likelihood that agreement will be reached.

President Alfonsin said the day before yesterday, I believe, in a public statement, that he hoped to send a letter of intent which would mean a successful agreement within the next 10 days or so.

Senator **Mattingly**. Mr. Mulford, would you say that the banks will profit from having this package place?

Mr. **Mulford**. Well, the banks certainly have had the advantage of having their interest arrears paid at the end of March. They have been a beneficiary of the arrangement, that's true.

Senator **Mattingly**. In other words, the LDC's continue to make sacrifices while the banks don't even have to take a hit with the quarterly earnings; is that correct? It seems like a pretty good situation if you're a bank, considering the alternative.

Mr. **Mulford**. I think what we've shown in our testimony is that there were other factors that were more important for the time being in the case of Argentina than that the banks should be a secondary beneficiary to this transaction. We tried to highlight those; namely, the new administration in Argentina, a country which has recently returned to a democratic path, struggling to establish its program, and it seemed to us important for the reasons already described that that should take place and that there should not be a major disruptive event taking place.

Senator **Mattingly**. It's sort of difficult to see that the bridge financing is really not benefiting the banks.

Mr. **Mulford**. I didn't say that it had not benefited the banks. I said that was not the prime objective and that the banks, as they were beneficiaries, were beneficiaries in a secondary sense.

Mr. **Solomon**. Mr. Chairman, if I may make a point, the central problem here—like was in the 1960's when we had all these debt problems in Latin America, even though there was no commercial bank debt to speak of—is can and will they go through reasonable adjustment programs?

Now there would be a serious problem of further capital flight from Argentina if Argentina had been the first major Latin American country to default, and that capital flight would have been an enormous problem for the Argentine authorities. I think that we should really recognize that the central point of this is not whether the banks benefited to the degree of one-quarter's interest. The problem for the banks is very much larger and they are prepared to reschedule and increase new money exposure to Argentina.

The problem is, will Argentina do a successful adjustment?

Senator MATTINGLY. Let me ask you this, then, just in conclusion. Do you agree that a positive step would be for the banks to lower the spread of these loans and allow them to become long-term obligations rather than short-term?

PERFORMING COUNTRIES NEED TO BE REWARDED

Mr. SOLOMON. In my view, if there is a successful IMF agreement, it is extremely likely, just as in the case of Mexico and Brazil, that spreads will be gradually lowered as the country shows performance and I think this will prove to go in the right direction.

There is an important principle involved which is that when countries perform they should be rewarded with lower interest rates and longer terms. If countries do not perform in the sense that they will not adopt IMF adjustment programs and will not comply with those programs, then I think it is a very strange situation to reward poor performers with lower spreads.

Now I realize there's a dilemma. There are a few countries that are workout cases you might say, but you have to handle the differentiation between good performing countries who follow IMF programs and poor performing countries. If you simply start giving interest rate concessions to poor performing countries, then you've got a very curious situation on your hands. That is not a normal debtor-creditor relationship.

I'm not excluding the possibility that there may have to be some special provisions in certain workout cases, but I would hope that all countries in their own interest would be encouraged to follow adjustment programs and become good performers and benefit from stretched out maturities and interest rate reductions.

Senator MATTINGLY. I will come back to that question. My time has expired. Senator Proxmire.

Senator PROXMIRE. Secretary Mulford, one could argue that debtor countries may have drawn the following conclusion from the Argentina rescue package. One, U.S. banks are highly vulnerable to a recorded loss on their foreign loans. Two, the U.S. Government is highly sympathetic to the financial difficulties of U.S. banks. Three, the U.S. Government is willing to commit its own funds to prevent losses being recorded on the books of the U.S. banks. Four, debtor countries now find that intransigence pays off, that they will win in the international game of chicken, knowing that when the chips are down the U.S. Treasury will come to their rescue.

What's wrong with that conclusion?

Mr. MULFORD. Well, it certainly is a position that one could take.

Senator PROXMIRE. Why wouldn't they take it?

Mr. MULFORD. In the testimony that I delivered, I think I already outlined a different position, namely, that in this case Argentina was regarded as an unusual country, recently reestablished on a democratic path. It was struggling to establish or correct a data base for negotiations with the IMF. It had gone through an experience prior to the end of last year of economic decline, capital flight, and rapidly accelerating accumulation of debt. So that strictly speaking, I don't think it can be compared that easily to all other debtor countries. It is a unique situation, as all these countries are.

As we approached the end of March, the banks certainly did not put pressure on the Treasury. We did not receive phone calls asking us to help them avoid an earnings loss. They appeared to me to have accepted that they would suffer such a loss and, as I said in the testimony, we were concerned by what we thought would be the result for Argentina if it allowed this development to take place.

Senator PROXMIRE. Of course, now you have created a situation in which in the future banks will say you've got this precedent; you did in the Argentine case. This isn't so different. We don't want to have these losses recorded on our books. How about it?

Mr. MULFORD. Well, we should remember that the initiative for this deal came from other debtor nations who made the judgment, first of all, that they might themselves suffer from a narrowing bank market toward Latin America; and second, it seems to me they also reached a conclusion that they all had an interest in seeing Argentina enter into an adjustment program, an arrangement with the Fund, and a rescheduling with the banks, as they themselves had done in certain cases beforehand. So that they were taking an initiative to bring Argentina more firmly into the cooperative system that the rest of them had themselves entered into some time before.

So it's hard to argue, it seems to me, that this sets a precedent for a less cooperative approach on the part of debtor countries in South America. It seems to me to have the reverse message.

Senator PROXMIRE. President Solomon, doesn't this give foreign countries that are borrowing an advantage over domestic private borrowers inasmuch as they can go through this kind of a situation and obviously the typical domestic borrower can't do it? At a time when interest rates are very high, not yet a credit crunch exactly but we're moving in that direction, and when interest rates are likely to go higher, doesn't an Argentine-type situation tend to discriminate against American firms that want to borrow?

Mr. SOLOMON. I don't see that, Senator Proxmire. I don't see why.

FOREIGN BORROWING WILL DIMINISH CREDIT AVAILABILITY FOR DOMESTIC BORROWERS

Senator PROXMIRE. Well, there's a limited finite amount of credit that's available and if we make that available to foreign countries, doesn't that diminish the credit that can be available to domestic borrowers?

Mr. SOLOMON. Well, first of all, the line of new credit that is being made available by the banking system is extremely modest to foreign countries because of the heavy debt exposure. The line of credit is important and all of us have urged that they cooperate with the IMF in extending that credit, but it's very small. It's running about 7 percent whereas it used to run 15 to 20 percent a year.

Senator **Proxmire**. This particular instance is, but in general, isn't the borrowing by foreign countries throughout the world a significant element or is it not?

Mr. **Solomon**. No; it's much smaller, sir, than it was.

Senator **Proxmire**. It's smaller than it was, but isn't it significant? Doesn't it have an effect on the total demand for credit?

Mr. **Solomon**. It obviously must have some effect, but it is so small. In fact, there's been a net inflow from the Eurodollar market because the foreigners continue to deposit in the Eurodollar market and the U.S. banking system abroad as well as at home. Because new lending has been reduced so much and the outflow is so small, there was actually a net inflow in 1983 of $26 billion from the Eurodollar market.

Senator **Riegle**. Would the Senator yield on that point.

Senator **Proxmire**. Yes, but I'll borrow time from you later.

Senator **Riegle**. OK. There's a big difference, however, between foreign capital sources loaning us money, and knowing we're going to pay it back because we pay our bills and have a decent credit rating, versus us extending credit to Third World countries that can't pay their bills. When you treat the two in the same equation as if there's no qualitative difference and that because other foreign money is coming into the United States because our interest rates are sky high, and that sort of cancels out our shoveling I think good money after bad money for further debts, I think is very misleading. I don't say that you intend that, but I think that it has that effect.

I thank the Senator.

Mr. **Solomon**. That's a different point, Senator Riegle. I was answering Senator Proxmire's question.

Senator **Riegle**. I understand that's a different point. But I think you leave a misleading impression on the record.

Mr. **Solomon**. Didn't you ask, Senator Proxmire, whether this foreign lending reduced the quantity of credit available to the borrower?

Senator **Proxmire**. Senator Riegle is next up and he will follow up when he gets a chance. He's not going to get a further chance on this particular question.

Senator **Riegle**. I thank the Senator.

Senator **Proxmire**. I'm delighted to yield.

Secretary Mulford, you mentioned that your second element in the strategy for dealing with problems with international indebtedness is, "Industrial countries follow policies leading to sustainable noninflationary economic growth in the industrial world." Doesn't this mean that the administration and the Congress must cut our deficit?

The IMF Director, a year or so ago, argued that the No. 1 obstacle preventing healthy world economic recovery was the U.S. deficits and, of course, that's before us right now. We're voting on the floor this week. We voted last week. We're going to continue to have that before us. So isn't the most constructive action the Federal Government can take is to reduce our spending, increase our taxes, and bring the deficits in this country under control? Won't that help the foreign countries more than anything else we can do? Isn't that at the heart of this?

Mr. **Mulford**. Well, I think it's fair to say that up until now in the economic recovery we've had in the United States, the deficit does not appear in fact to have had a negative effect.

Senator **Proxmire**. Well, it raised interest rates internationally, hasn't it?

Mr. **Mulford**. But it's recognized as a problem and, as you say, there is at this time an initiative underway to reduce the deficit through a package referred to as a downpayment.

Senator **Proxmire**. Hasn't it soaked up capital from all over the world? Hasn't it kept interest rates high in Central and South America and all the developing countries in the world?

Mr. **Mulford**. Well, I think that's overstating the case and perhaps making it a little too simple.

Senator **Proxmire**. Isn't it true?

Mr. **Mulford**. It's true that the deficit certainly is a factor in that scenario, that's correct.

Senator **Proxmire**. Do you disagree with the Director of the IMF that it is the most serious of obstacles facing the world recovery?

Mr. **Mulford**. I don't agree with that assessment, no.

Senator **Proxmire**. President Solomon, as you know, the statute governing utilization of the Exchange Stabilization Fund allows its use to maintain orderly exchange rate arrangements and a stable system of exchange rates. I'm trying to get at the legal basis for what's been done here. I don't believe Congress ever contemplated such funds would be used to provide bridging loans to a country to pay interest to banks on its international debt. If that type of use can be justified, are we not really providing the executive branch a $12 billion fund to be used at its discretion?

Mr. **Solomon**. Well, sir, you remember when I was Under Secretary you were chairman of the Banking Committee and we did a bridging agreement for Portugal, and the administration before for the United Kingdom. It's a bridging agreement to an IMF adjustment program with the first drawings from the IMF to be repaid to the Exchange Stabilization Fund. That was what was done for Mexico and Brazil, as we pointed out earlier.

ESF SUPPORTS IMF OBJECTIVES TO STABILIZE INTERNATIONAL SYSTEM

I think that there's a clear intention on the part of the Congress that we should use Exchange Stabilization Funds [ESF] to support the International Monetary Fund objectives with regard to a stable international monetary system, and this is consistent with that, I believe.

Senator **Proxmire**. You don't think we're establishing new precedents here?

Mr. **Solomon**. No, I don't.

Senator **Proxmire**. For example, couldn't some future administration later attempt to justify using Exchange Stabilization Funds to aid some Central American government to stay in power because its fall might have an impact on interest or exchange rates?

Mr. **Solomon**. I think that would be clearly inappropriate use of the Exchange Stabilization Fund and I see no evidence that anybody would think along those lines at the Treasury. The whole key is, is the country negotiating with the IMF to reach an adjustment program or a Letter of Intent? In this case, the Treasury was actually very conservative because they said they would not extend the credit until the actual Letter of Intent was signed, whereas in the case of Mexico and Brazil, it was in anticipation of the successful conclusion.

Senator **Proxmire**. Do you think Congress ought to provide more statutory guidance?

Mr. **Solomon**. No; we're the richest country in the world. We have to have a little bit of flexibility to handle an emergency situation. In other industrialized countries, the central bank can lend to the IMF, for example. Here, we are prohibited by statute. It seems to me that it would be highly inappropriate and counter to what the Congress wants to remove that bit of flexibility that the U.S. Government has for these kinds of difficult situations.

The Treasury has handled itself I think with considerable restraint. They have not used the Exchange Stabilization Fund very much and certainly if I were still in the job that I was in in the earlier administration I would have done the same thing.

Senator **Proxmire**. Let me ask Secretary Mulford, can you furnish the committee with existing regulations and Treasury Department legal memorandums concerning the Fund's use?

Mr. **Mulford**. Yes, we can.

[The following information was subsequently supplied for the record:]

The ESF was established by the Gold Reserve Act of 1934, which originally provided the following:

"For the purpose of stabilizing the exchange value of the dollar, the Secretary of the Treasury, with the approval of the President, directly or through such agencies as he may designate, is authorized, for the account of the fund established in this section to deal in gold and foreign exchange and such other instruments of credit and securities as he may deem necessary to carry out the purpose of this section . . ." (P.L. 73-87, Section 10 of the Gold Reserve Act of 1934.)

With the termination of the fixed exchange rate system and the 1978 amendments to the IMF Articles of Agreement, the ESF was amended in 1976 (effective 1978) and 1977. For example, the provision "for the purpose of stabilizing the exchange value of the dollar" was dropped. The statute now provides as follows:

"Consistent with the obligations of the Government in the International Monetary Fund on orderly exchange arrangements and a stable system of exchange rates, the Secretary of an agency designated by the Secretary, with the approval of the President, may deal in gold, foreign exchange, and other instruments of credit and securities the Secretary considers necessary. However, a loan or credit to a foreign entity or government of a foreign country may be made for more than 6 months in any 12-month period only if the President gives Congress a written statement that unique or emergency circumstances require the loan or credit be for more than 6 months." (31 U.S.C. 5302(b).)

The language, "consistent with the obligations of the Government in the International Monetary Fund on orderly exchange arrangements and a stable system of exchange rates," was inserted in order to conform the purpose of the ESF to the revised IMF Articles to clarify that "the ESF is to be used only for purposes consistent with U.S. Obligations in the IMF." (Senate Report 94-1295, 94th Congress, 2nd Session, June 22, 1976, p. 17.)

The obligations of International Monetary Fund (IMF) members are set forth in Article IV of the Articles of Agreement, and include:

(1) Endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;

(2) Seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions;

(3) Avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members; and

(4) Follow exchange policies compatible with the undertakings under this Section.

The legislative history of the Gold Reserve Act and of its amendments indicates clearly that the intent of the Congress was that ESF financing may specifically include loans or credits to foreign governments. This intent was reaffirmed by the 1977 amendment which placed limitations on the terms of the financing which the Secretary is authorized to extend to foreign countries. The legislative history indicates that the intention of the Congress was to assure that ESF credits are short-term and used to support the role of the International Monetary Fund as the principal source of official balance of payments financing:

"In order to insure that ESF lending operations are not inconsistent with the goals of the IMF, the Committee has adopted an amendment emphasizing the intended short-term nature of ESF lending. The goal is for the United States to place primary reliance on the IMF and to confine foreign exchange lending operations outside the IMF to short-term operations. Under the amendment, the ESF would be barred from extending loans to a foreign government for more than six months in any twelve month period . . . . unless the President provides a written determination . . . ." (Senate Report 94-1295, 94th Congress, 2nd Session, September 22, 1976, p 11; see also House Report 94-1284, 94th Congress, 2nd Session, June 21, 1976.)

Since late 1982, ESF short-term financing has been one element of the U.S. strategy for dealing with the problems of international indebtedness, which has posed a major threat to the international monetary system. This strategy, which was endorsed by the major industrial countries at the 1983 Williamsburg Summit, includes:

(1) Adjustment by the debtor countries;
(2) IMF assistance in support of effective adjustment programs;
(3) Emergency government and central bank assistance;
(4) Continued commercial bank lending; and
(5) Sustained world economic growth with open markets.

The third element in the overall strategy, noted above, is for governments and central banks to act quickly to provide short-term financing where needed in exceptional situations to support a country's adjustment efforts. Problems may arise rapidly, and financing may be needed immediately to enable debtor countries to have the time to negotiate agreements with the IMF. We are undertaking this, where necessary, on a case-by-case basis, through arrangements often involving financing by other countries.

The current ESF arrangement with Argentina is an important instance of the implementation of our debt strategy. Under this arrangement, the ESF's resources cannot be drawn until Argentina agrees on a letter of intent with the IMF for a new adjustment program. In making the commitment, our objective has been to join other parties, including Latin American governments and the banks, in supporting Argentina's adjustment efforts; thereby strengthening the operations of the international monetary system. This objective is certainly consistent with U.S. obligations in the International Monetary Fund regarding "orderly exchange arrangements and a stable system of exchange rates."

Accordingly, both the statute and the legislative history of the ESF fully support the actions taken by the Treasury with respect to the swap agreement with Argentina.

Senator PROXMIRE. My time is up. Thank you.

Senator MATTINGLY. Senator Sasser.

Senator SASSER. Secretary Mulford, in your opening statement you indicated that Argentina had a total external debt of slightly over $40 billion, $25 billion of that owed to foreign banks. One-third of that $25 billion is owed, if I read your statement correctly, to U.S. banks.

Who are the principal creditors other than U.S. banks to Argentina?

Mr. MULFORD. Well, the syndicate of banks is made up by a wide selection of banks based all over the world— European, Japanese, Canadian, and so on. It's an international syndicate. In fact, the banks which made the $100 million loan were, as I recall, comprised of five U.S. banks and six non-U.S. banks.

Senator **Sasser**. The banks of which countries hold the principal portion of this debt other than U.S. banks?

Mr. **Mulford**. I can't off the top of my head answer that question, but I can supply that to you.

Senator **Sasser**. Would you get that information and supply it for us, Mr. Secretary?

Mr. **Mulford**. I certainly will.

[The following information was subsequently supplied for the record:]

Other countries for the most do not compile and publish data comparable to the U.S. Country Exposure Lending Survey. The United Kingdom is an exception; UK-registered banks had claims on residents of Argentina as of end-June 1983 of $3,169 million (unadjusted for guarantees).

I would note, moreover, that the Bank for International Settlements does publish an aggregate figure for outstanding claims of all banks in the BIS reporting area. That figure for Argentina, as of end June 1983, amounted to $25.5 billion. Thus, after deducting the claims owed by the U.S. and U.K. banks, the other countries held $13.6 billion of Argentina's bank debt.

Senator **Sasser**. I think that would be very helpful.

Mr. Solomon, the recent history of the Argentina debt problem reads very much like a series in the "Perils of Pauline." Obviously, the common goal is to get by or get beyond a crisis scenario.

Now I'm concerned that we are not going to be able to make this thing fly because of what's happened to interest rates here in the United States. As I read Secretary Mulford's statement, he alluded to the fact that each percentage point of interest rate increase, for example, results in additional net annual payment for non-OPEC LCD's of about $2 billion or around 5 percent of their aggregate current account deficit in 1983.

Now some economists I have seen indicate that each uptick in U.S. interest rates of one point increases Argentina's interest payments by $700 million and you've got the same problem in Brazil, and so forth. Other economists have said that a 12 percent interest rate is the maximum rate at which we can expect to have any solution to these problems; that is, any meaningful solution that can be sustained.

Now we are at 12 percent here in the United States. You may not have had the opportunity to read the Wall Street journal this morning, but there is an article in the morning journal in which Mr. Frank Morris, your counterpart at the Federal Reserve Bank of Boston, apparently stated in an open meeting to economists—or in a meeting that he perhaps thought was closed—that at the March 26–27 meeting of the Federal Open Market Committee, steps were taken to tighten monetary policy. The fear is that the economy was becoming overheated and this report has caused some consternation at the Federal Reserve I understand, and in some areas of the Treasury Department.

INTEREST RATE RISE COULD AFFECT LONG-TERM SOLUTION

My point is this. We are at 12 percent now. Apparently, one participant in the Open Market Committee meeting is indicating that steps were taken in March to tighten monetary policy which would indicate that rates may go even higher. How high do you think rates can go and still allow us to work out some sort of meaningful, long-term solution to this problem in South America?

Mr. SOLOMON. Well, I can't answer that in quantitative terms, but let me say this, Senator. We have an obligation, both domestically and internationally, with the dollar-based international monetary system and all other interests involved, to prevent this country from returning to double digit inflation.

Second, in this era of deregulation, if we have double-digit inflation again, interest rates will go up. And the LDC's, the heavily indebted LDC's, are still going to be hit with the problem. We should not lose sight of the fact that even though we at the Fed are, I think, extremely sensitive, as you know, to the international debt problem, we also have to be concerned about inflationary expectations both in our own immediate interest and in the interest of the developing countries. They're not going to be helped, they're going to be hurt this time by inflation. Previously, inflation used to bail them out when our interest rates were regulated because their commodity prices would go up faster than interest rates in dollar-denominated debt. Today, with deregulation, we have seen clearly that that doesn't happen.

Therefore, it does not hurt them and it helps them in many ways if we retain control of the inflationary problem.

Now the question of how much monetary control tightening in any particular period of time is necessary to hold that control—I assume you don't want me to get into the usual kinds of discussions on that at the moment, but in terms of relevance——

Senator SASSER. Mr. Solomon, you may have misinterpreted my question. I'm not being critical of the Fed's policy at this particular time. Now, when Mr. Volcker appears here, I might have some questions for him about that and I reserve the right to be highly critical of the Fed's monetary policy when Mr. Volcker appears. But obviously I'm not today trying to make you responsible for what happens on any Open Market Committee. My real question is, What's going to happen here with these sorts of patchwork arrangements that we've worked out, for example, with Argentina, as our interest rates go up here in the United States? What is your judgment or the judgment of your colleagues at the table here with you today about how high these rates can go and still allow us to have some sort of sustainable solution south of the border, so to speak?

Mr. SOLOMON. Well, it would depend upon how successful they are in increasing their exports, whether they follow realistic exchange rate policies' and how successful they are in getting capital flight returned to Argentina by following positive real interest rates policies in that country. That obviously will determine or influence significantly what size interest burden they can handle, and I certainly have no way of giving you an estimate of what they can handle without getting into a discussion of all the other factors as well.

Certainly, it is clear that any increase in interest rates adds to the immediate burden. There's no question about that. On the other hand, it is also true that the size of the burden that a country can carry and be creditworthy or work its way out of a difficult situation will depend upon its exchange rate policy, its budgetary deficit, and its positive real interest rate.

FLIGHT OF CAPITAL FROM SOUTH OF THE BORDER

Latin America—and Argentina is one of the most conspicuous cases—has lost $40 to $50 billion in capital flight in the last few years just by following very poor policies in regard to overvalued exchange rates and negative real interest rates. On top of that, through no fault of their own, of course, there's also been a world recession in which commodity prices have dropped. At the same time, their dollar denominated debt continues to grow.

So you have a whole complex of circumstances and the fault does not lie exclusively externally or internally. It's a combination of those factors, but they must follow intelligent adjustment policies because there's no other way you can handle a situation with that much capital flight and it's really essential, as I see it, as part of the adjustment program for Argentinians to return part of their capital at least. There's no way of achieving that return except by restoration of confidence that they will be following that kind of policy.

Senator SASSER. Was any of this capital flight, in your judgment, precipitated by the high interest rates here in the United States, attracting foreign capital in here to finance our deficit? Or is it all just fleeing the country out of fear of economic chaos that may result in Argentina or other less developed countries south of the border?

Mr. SOLOMON. The high real interest rates are a factor in attracting funds from the entire world, including Latin America. I would say, based on my many years of experience in Latin America as well as handling those problems from Washington, that the main problem has been in the case of Argentina, Venezuela, and Mexico, a loss of confidence by the citizens of those countries in regard to the policies that were being followed and an increasing fear that they were going to take a terrible hit and they got their money out.

There's no doubt in my mind, because we have seen the situation at other times where we have seen enormous floods of capital flight running out of countries because of loss of confidence by their citizens in the policy that their government was following, irrespective of what real interest rates were in the United States or any other industrialized country.

Senator SASSER. One parting shot, if I may, Mr. Chairman, let me quote Secretary Mulford's statement:

> We made the judgment early in March that the earnings penalties that would be suffered by the U.S. banks would be sustainable without a threat to the system. However, we fear that Argentina's failure to pay interest arrears by March 31 could pose a significant threat to its creditworthiness and its ability to restore a sound economy.

Mr. Secretary, that statement really wouldn't sell very well on Main Street. The majority of my constituents don't really care much about Argentina's creditworthiness or whether or not we work to restore a sound economy there. Many of them would fall back on the statement that Calvin Coolidge made some decades ago that's come into recent prominence. To quote President Coolidge, I think they would say, "They hired the money, didn't they?"

So from a political point of view, we're going to have to come up with a better explanation than that, those of us who have to face the voters.

Senator MATTINGLY. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

I think we have a very, very serious problem here and I'm skeptical about what I see taking place in terms of the flow of events—not just this transaction, but this transaction in the context of a much larger picture. It looks to me as if we're sinking into a deeper and deeper hole and I'll get into the questions which bear out whether we are or are not finding ourselves with that situation, but I see this latest move as another finger in the dike in a way that is not in any manner a sufficient substitute for a comprehensive economic and financial strategy.

I'm not just talking about dealing with Third World countries that can't pay their debts. I'm talking about reconciling with our trade deficit, reconciling with our Federal fiscal deficit, reconciling it with our record high interest rates, reconciling with the flow of capital in the United States in response to our record high interest rates, flight of capital as well, and the fact that this is obviously lifting interest rates all around the world, certainly in the less-developed countries it's putting a greater stress on their economic circumstances. And in the case of Argentina, in effect, they decided they wanted to fight the Falkland Islands war not very long ago and it cost them a lot of money and somebody now has to come along and in effect pick up the tab for that and for the harm that's done in their own economy, and here we come with this very tortured device that was crafted here to move this money around to avoid the day of reckoning down there.

Now it seems to me—and I just want to say, Mr. Solomon, to come back to my point when Senator Proxmire yielded—it's a very different situation when a foreign country or foreign suppliers of credit are taking U.S. debt instruments, sending money into this country, attracted by our high interest rates, because they know they can redeem those instruments. They can sell them at any time or they can wait until the redemption comes and they're going to get paid. So those people lending us money have an assurance that's fundamentally different than the assurance that we have today or our banks have in terms of extending further credits to underdeveloped countries who have a record now of being unable to pay their bills.

It isn't just in this hemisphere. It's Poland and it's other places as well. So there is a fundamental qualitative difference when you take those two kinds of transactions, with us loaning money out that we can't get back into credit instruments that are highly questionable in terms of their liquidity, versus other countries loaning us money where they know they can be repaid and they can sell those instruments.

Those are profoundly different things and in any context to relate those two flows and to indicate, even unintentionally, that these are compatible transactions I think is quite incorrect.

SOME THIRD WORLD LOANS ARE BEYOND THE POINT OF PRUDENCE

I think we're caught in a situation here where foreigners may decide at some point they don't want to lend us all this money and yet we're going to find ourselves stuck with a lot of these Third World loans which we have made I think beyond the point of prudence.

Now there's no way to wave a wand and solve the problem. It's going to be a long, hard struggle to work our way out of it, but that's where the absence of some kind of a comprehensive strategy of which these moves could be part—the absence of that comprehensive strategy troubles me. Senator Proxmire referred to it earlier. You've got the President himself saying that deficits don't matter in this country in the sense that they don't seem, in his mind, to have any connection to interest rates. He said that to the builders in a major speech 2 weeks ago. And your boss, Secretary Regan, says the same thing and gets upset every time that anybody tries to connect high Federal deficits in this country to interest rates. But we've got the high interest rates and the high interest rates are making this foreign debt problem far worse and I think, in fact, they prevent us from solving it unless we are going to do something material about getting our interest rates down and, in turn, worldwide interest rates down.

As I look around, I look at Brazil, we've had the riots in the Dominican Republic, we've got the problems in Peru, and we're talking here about Argentina, and we've talked about Poland, and a much, much longer list. It seems to me that what is missing is any kind of an overall strategy. We're going from 90-day periods to 90-day periods.

The fact is that we see right now in the case of Argentina that they are about $2 billion in arrears on just the interest, in addition to the $43 billion that they have outstanding in foreign debt. And we've just seen again another delay by Argentina on April 30 in terms of their ability to reach the deadline for an agreement with the IMF at that time. Isn't that correct, Mr. Mulford? Didn't we get to April 20 and find that they were unable to work things out with the IMF?

Mr. MULFORD. When they got to April 30, they had not completed their discussions with the IMF. I can comment on that further if you wish.

Senator RIEGLE. Well, let me go on and then we can come back to that. The fact is, the intention was to have it done by April 30 and it's not been done; is that correct?

Mr. MULFORD. When the arrangement was made, there was a hope that it would be done by that date, and the expectation was that it would be, but I think it's fair to say that the fact that it's run over April 30 is not as surprising as it might appear.

Senator RIEGLE. Let me ask you this. Can you give an assurance today to the committee personally and professionally that when we get to June 30 that the American banks are not going to face the same overdue interest problem in that quarter that they have just faced now with Argentina? Can you give us that assurance?

Mr. MULFORD. Well, I cannot give you that assurance because none of us know at this point whether in the final event Argentina and the Fund will reach an agreement on an adjustment program that will enable them to sign a Letter of Intent.

Our feeling at the moment is that the technical problems which have been quite severe have pretty well been cleared up. We understand there's another 7, or 8, or 10 days of work to be done to resolve the technical differences, and at that point it becomes a question of Argentina and the Fund determining whether they can agree. In the case of Argentina, I believe this will mean discovering whether Argentina has the political will to make the necessary decisions to make an adjustment program work.

Senator RIEGLE. Well, I hear that, but the bottom line is that you feel you can't give us that kind of professional assurance today, that's what I asked for and you responded frankly and I think that's the answer that counts here.

Now let me ask you this. In a decision last week the U.S. Court of Appeals for the Second Circuit appears to have given debt-ridden developing countries much the same legal protection for commercial bank creditors that is now accorded troubled domestic corporations under chapter XI of our bankruptcy laws. Accordingly, as I understand it, U.S. banks might be left without legal recourse if a foreign country stops payments on its debts.

I'm wondering what is your present understanding regarding the legal recourse of our banks in such a situation in light of that legal finding?

Mr. MULFORD. Are you asking me?

Senator RIEGLE. Well, whoever would like to respond. It hits you all.

COURT RULING COULD CLOUD BANKS RIGHT TO COLLECT

Mr. SOLOMON. Well, I'm not a lawyer, but I have spoken with my lawyers at the New York Fed and as I understand the situation, there is some doubt that this ruling would be upheld.

You had a situation where all the banks were willing to spend the time necessary but that 1 bank out of 39, I believe was not, and the court interpreted the fact that there had been statements of support for Costa Rica from the U.S. Government as meaning Costa Rica could unilaterally, under the rubric of the foreign exchange controls, determine what maturities should be and what interest rates should be.

It seems to me that there's a good likelihood that that opinion would be modified on further consideration either by that court or by the Supreme Court.

Senator RIEGLE. Were it not to be, how big a complication do you see it as being?

Mr. SOLOMON. Well, I think it would be a significant complication if it would not be modified, and it's not clear what it would do. It certainly would limit the ability of banks to bring litigation, successful litigation, against a unilateral imposition of terms by a sovereign debtor government. But I think, though, Senator Riegle, it's a very complicated situation and I would be reluctant to go too far because I am not a lawyer and I think there's a lot of questions among the lawyers.

Senator **Riegle**. We don't have the time to pursue it further now because I want to move to something else, but I think it's an important reference point in the combination of all of these difficulties which are coming in from different directions and which are not resolved in any kind of an overall coherent, comprehensive policy.

In fact, I heard the political argument woven all through your testimony, Mr. Mulford, when you were saying in a sense this is a new democracy in Argentina and we were sort of making a special intitiative and effort in their case because they are a new democracy, and you nod your head when I say that——

Mr. **Mulford**. Could I answer that question?

Senator **Riegle**. Well, let me just finish it. So I asked myself the question, would we do the same thing for other nations with whom we are allied in that part of the world who are not democracies? In other words, on top of the financial considerations, is there an additional political consideration whether it's a democracy and a new democracy that somehow differentiates Argentina from Peru, or Brazil, or some other nation in that part of the world?

Mr. **Mulford**. Well, first of all, the Argentina case was different from other cases for the reasons that I explained, and second, each of the countries has a different set of circumstances. But I would like to say that in the opening sections of my testimony, I did outline a strategy that is a comprehensive strategy. Unfortunately, we don't believe that it's possible to achieve a comprehensive solution to a problem as widespread and complex as the problem we are talking about.

But I do wish to point out that there is a five point strategy which has been contemplated, discussed, and agreed, and then was endorsed by the seven heads of state at Williamsburg last year, and that can be summarized in the five points which appear on page 1.

Senator **Riegle**. Well, let's just stop right there, and my time is up, but I recall the Williamsburg Conference and there was great concern about Federal deficits in this country and the resulting impact of driving interest rates higher than they needed to be—higher levels than were sustainable in terms of the world economy and particularly the Third World debtor countries. Frankly, we've done next to nothing about it. Interest rates are rising today. They are not going down. They are going up. So we have defaulted on the centerpiece of commitment that proceeded to be followed through on at the Williamsburg Conference, and we got a lot of sophistry and a lot of arm waving out of the administration on all different things it's doing, but it's not doing the things it needs to do to make any kind of strategy work.

If interest rates continue to rise, you can't find one economist of consequence in this country who's prepared to say that we could solve the international debt problem in the face of the rising interest rate picture. I would doubt, Mr. Solomon, that you would be prepared to argue we can stop it if we're going to be faced with a picture of rising interest rates. And that's what we have on our hands.

So when you say you have a strategy but you don't have an answer for that problem or even an initiative that's designed to turn that around right now, I think it's an empty assertion on your part.

My time is up, Mr. Chairman.

Senator **Mattingly**. I always like to check with my colleagues with reference to interest rates. I would like to ask them to remember that just a few years ago in 1979 and 1980, what were the interest rates then? And there has been a lowering of interest rates and I think we ought to wait until all the votes are in to find out what the score is on interest rates now. As I recall, when I was back in the private sector, it cost a little more to borrow money back in 1979 than it does in 1983 and 1984.

Senator **Riegle**. Are you talking about real interest rates?

Senator **Mattingly**. I'm talking about real interest rates.

Senator **Riegle**. In other words, the rate of interest over and above the inflation rate?

Senator **Mattingly**. I'm talking about how much I had to pay out of my checkbook every week or month.

Senator **Riegle**. You're talking about nominal rates, not real rates.

Senator **Mattingly**. That's what I call real rates. For those of you who have not been in the private sector for a while, that's what real rates are.

I've got a broader question that I'd like to address and it goes back to a question I asked in the opening statement about why are the U.S. commercial banks rather than the U.S. Government making key decisions regarding the viability of the new Argentine Government?

KEY DECISIONS TO BE MADE BY ARGENTINA

Mr. **Mulford**. Well, the key decisions for Argentina are going to be made by Argentina, and that is the process that is presently underway in which they are attempting to determine what sort of economic program they must have in order to stabilize their economy and place it on a basis which restores economic growth.

Involved in that is a wide variety of difficult economic and political decisions, and Argentina must come up with some answer to that and design a program which in this context is accepted by the IMF as the basis for an IMF standby program which would provide funds for Argentina; then go forward and begin the adjustment. The commercial banks would come in behind that and negotiate a package for rescheduling and new money that would also contribute to this process; this would probably be followed by discussions for rescheduling official debt.

The overall effect of all of these programs, if they do get brought in behind an IMF agreement, would be to assist in carrying out the decisions which must be Argentine decisions—I'd like to emphasize that because it is a question of domestic politics—them coming up with the right decisions to restore the basis for economic growth in Argentina. That's where the crux of the decisions lies.

Senator **Mattingly**. If this package is so good, it certainly makes me wonder why the United States has to be involved in it at all. Couldn't the whole arrangement have been concluded without the United States? That is, if the idea of the $500 million bridge loan from the banks for Argentina and four Latin American nations is so good, why does it really need the United States?

Mr. **Mulford**. Well, let me answer that, because I was in Argentina during the negotiations down there for the Treasury.

First of all, the $300 million from the United States will not be put out until a Letter of Intent is signed. The United States was unwilling, without the Letter of Intent and the program in place, to make a bridge loan to Argentina. The Latin American governments made this initiative and the United States faced several problems.

One was, should it turn its back on that initiative? If it did, what would happen if the four governments went forward with their plan and it failed? They might have been extremely disgruntled governments, having failed in putting together a package of this sort. Or if the United States turned its back on it and those governments had succeeded in coming up with a package, then perhaps we would be reading today in the newspapers more about the supposed debtors' cartel which, if the United States had turned its back on it, would have allowed to have a great success.

Our view was that we should associate ourselves with the package in some way, because we had already demonstrated an interest in Argentina's new course. We've supported Argentina and we came up with a method by which making an advanced commitment that could only be drawn in the event the Letter of Intent was agreed, would act as a sort of support arrangement and make the deal doable, and that in the event was what we did.

Senator **Mattingly**. Were there any other plans considered other than this plan?

Mr. **Mulford**. No, there were not, not by the United States. We had decided that we would not do a bridge loan without the Letter of Intent in place.

I'd like to make one more comment, and that is, the Latin American governments, as you know, are themselves short of funds; they looked at this purely as a short-term bridging arrangement where they were putting up their money and, of course, they would attempt to influence Argentina in the direction of coming up with a Fund agreement. Our function is to provide bridging financing after the Letter of Intent which then takes out the Latin governments. So they are not exposed for too long a period; they have a shortage of funds, and this is a normal function for us—and has been in the past—in bridge financing.

Our risk then is after the Letter of Intent, until the Board of Directors, of the Fund authorizes the Fund program to go ahead. That's a period usually of 30 to 60 days.

Senator **Mattingly**. I only have one more comment and then, Senator Proxmire, I'll let you ask your questions.

Getting back to the banks, I think we've got a responsibility to take the leadership, not only as Senators but you, as the administration to encourage banks to lower those rates and stretch out those loans. We can't just say it's going to be done by somebody somewhere. Someone is going to make this recommendation and the banks are going to abide by it eventually or at least try to do it. I think the direction has to come from us to the IMF. We say the

United States is the only one that has a veto. It's never been used. I think maybe there ought to be a recommendation.

Mr. SOLOMON. Senator, the IMF does make the recommendation that there be a stretchout of loans by commercial banks and that there be new money, because otherwise they can't put together the financing for the adjustment program. That has been a condition of every one of these situations.

Senator MATTINGLY. I know it's been a condition. It's just not abided by.

Mr. SOLOMON. It is abided by. In the case of Mexico, Brazil, Chile, Peru—every one of these, the IMF has required before it will send its adjustment program to its executive board for approval—it requires that it have assurance from the commercial banks or the creditors as to the rescheduling of the maturities and the amount of new money that will be required to put the financing package together to make the program sustainable. It's followed that very consistently ever since the debt crisis developed.

Senator MATTINGLY. Well, I'll just have to see after this debt package if anybody refers to any of the loans as nonperforming loans.

Senator Proxmire.

DISCUSSION OF BANKS' INVOLVEMENT NEEDED

Senator PROXMIRE. Mr. Mulford, in your testimony before the House on Tuesday you said that, "Argentina is involved in intensive work with the IMF to lay the basis for an IMF agreement."

I understand that normally when a country negotiates with the IMF, it also carries on concurrent negotiations with the banks so that the total adjustment program is reached. In fact, you state in your testimony, "Argentina and the commercial banks are in the process of negotiating the terms for rescheduling of existing Argentine debt and the extension of new credit."

I understand from the bankers, however, that negotiations with the banks are not proceeding in this case. In fact, you also said in the House, "There have not been productive discussions with the commercial banks so far."

Now can you tell us why Argentina is not pursuing negotiations with the concerned commercial banks at the same time it pursues negotiations with the IMF as do other countries?

Mr. MULFORD. Well, I can make an attempt at it, although I'm not one of the bankers and therefore might not see it the same way.

As I understand it, the negotiations with the banks have been complicated by the fact that agreements were reached between Argentina and the banks prior to late 1983 under the previous regime in Argentina, and the present Government in Argentina takes the view that it would like to have certain aspects of the 1982 and 1983 agreements reopened for discussion on terms, the terms that apply to those agreements. The banks are very reluctant to do this and there's a variety of other issues which are complex, legal issues of one kind or another, which the banks and the Argentine Government are disputing, which were agreed previously by the prior administration in Argentina.

I think this has complicated the discussion, but the present situation is that the banks appear to be waiting for Argentina to come to an IMF agreement before entering into serious negotiations on putting together a new package, and the Argentine Government appears also—although there have been meetings from time to time over the past months—to have for the time being withdrawn to the sidelines as well.

So it appears that what's going to happen is that the IMF agreement, if it's reached, will be reached first and then there will begin a period of really intensive negotiations between the banks and Argentina to put the rest of the package together. My guess is that this will have to be done between the signing of the Letter of Intent and the confirmation of that.

Senator Proxmire. Can you tell us whether or not that will cause any delay in the Board of Directors approving any Letter of Intent signed by Argentina and the Fund's Executive Director?

Mr. Mulford. I can't tell you whether it will cause a delay, but my personal guess is that this could be lengthy process and it could cause delays.

Senator Proxmire. The reason I ask that is because in your testimony before the House you said that the $300 million loaned by the United States will be at risk during the period between the signing of the Letter of Intent and the action of the IMF Board which releases the Fund money so they can pay us back. You also said, "Normally, that takes 30 to 60 days." You then said, and I quote from the transcript, "If the events took place during that period which forced Argentina out of compliance with its program, there would be a risk of delays."

Can you tell us what possible events you were referring to?

Mr. Mulford. Well, the events that could take place would be events in Argentina that might cause them to go out of compliance with the arrangements already agreed to in their Letter of Intent.

Senator Proxmire. Is the fact that Argentina is not yet carrying out negotiations with creditor banks creating a greater risk?

Mr. Mulford. I think that the negotiations with the banks pose a rather special problem in Argentina's case and do involve a risk.

Senator Proxmire. So there might be a longer period?

Mr. Mulford. There could be and I was attempting to give an accurate account of that risk.

Senator Proxmire. Now as I understand the debt problem in Latin America, we have a situation in which the entire proceeds of new loans go to pay the loan fee and interest on existing debt. So that on balance, the borrower doesn't obtain any new funds. If interest rates continue to go up because of the budget deficits or whatever other reason, if they do go up, why won't a country like Argentina decide that it's in its best interest to declare a moratorium on its debt?

Mr. Mulford. Well, I think it depends on how high interest rates go. If there's some modest rise in interest rates obviously this produces an additional burden, but it doesn't seem to me necessary that that should be a burden that would cause them to reach that conclusion.

Senator **Proxmire**. That's a pretty frustrating situation when you borrow money and all you can do with the money is pay the loan fee and interest on the existing debt.

Mr. **Mulford**. That is correct, but in the situations where adjustment has been taking place, the prospects for a more acceptable arrangement are emerging. Take, for example, Mexico, where real progress has been made.

Senator **Proxmire**. What keeps Argentina from declaring a moratorium?

Mr. **Mulford**. Well, for a start, they have a long history of honoring their debt obligations. That's important in any country's tradition. Second, obviously, all countries that would contemplate such an action must take into account the effect this would have on their ability to raise new capital in financial institutions around the world.

If they declare a moratorium, they are effectively cutting themselves off from new sources of capital.

Senator **Proxmire**. Mr. Solomon, the Managing Director of the IMF said in a speech in December that credit by private banks should be provided on reasonable terms in order not to compound unduly the balance-of-payments and indebtedness problems of the debtor nations.

Now in view of our important interest in the political and economic stability of Latin America, is the administration taking any role, in your judgment, in insuring that the private banks are providing reasonable terms to Latin American nations?

Mr. **Solomon**. Well, you're asking me to comment on the substance or the administration's role?

Senator **Proxmire**. Well, the substance and the administration's role.

REDUCTION IN THE SPREAD

Mr. **Solomon**. Well, on the substance, there has been a reduction in the spread in the fees that the banks are charging Mexico and Brazil from the earlier spreads that they were charging and there's also been a reduction in the fees.

Senator **Proxmire**. How big a reduction in the spread?

Mr. **Solomon**. Well, in the case of Mexico, it was I think a reduction of three-quarters of 1 point, from 2¼ over LIBOR to 1½ in the last $3.8 billion loan that was just put together of new money to Mexico, compared to the earlier one.

Senator **Proxmire**. How many countries have enjoyed a reduction in the spread? Mexico is one.

Mr. **Solomon**. Well, Brazil also has had a reduction. I'm not too familiar with the sequence in regard to Peru, Chile, and some of the other smaller countries. I could send you that.

Senator **Proxmire**. I would appreciate that for the record.

[Data were submitted to the staff of the Committee on Banking, Housing, and Urban Affairs on reductions in fees and interest rates and lengthening of terms reflected in recent renegotiations for Mexico, Brazil, Peru, Chile, and Yugoslavia. All these loans showed a reduction in spreads although less than what Mexico received. See pp. 90–95.]

Senator **Proxmire**. Are we taking any steps to devise an orderly procedure for evaluating the structure of each country's debt and its ability to repay its past and future borrowings?

Mr. **Solomon**. Yes. The IMF has a very careful evaluation of the country's ability to pay based on certain sets of policies regarding exchange rate, budget deficit, and so forth. Then it says to the commercial banks and to the governments that this is the situation, this is the financing gap, and this has to be met, and it will even suggest guidelines on how that should be divided up among the collective commercial banks and the possibility of new money.

So, I think there is a very careful evaluation of the country's ability to pay under a proposed IMF adjustment program and assurance that those funds will be available before the Executive Board of Directors gives its approval.

Senator **Proxmire**. Secretary Mulford, I'd like to ask you a question following up on something I said in my opening statement. You referred in your testimony in the House to "the Treasury Department's efforts to insure that U.S. policy on IMF loans to Argentina conforms to sections 806 and 807 of the IMF legislation."

Now those provisions, as you know, reflect congressional concerns that commercial banks play a responsible role in resolution of the debt crisis. It appears to me that the Treasury will, by advancing $300 million to Argentina, after it signs the IMF Letter of Intent, create a conflict of interest for itself.

How can our representatives to the Fund feel free to oppose any proposed IMF program for Argentina that is inconsistent with sections 806 and 807 of the IMF legislation; if to do so jeopardizes the $300 million we would be lending to Argentina?

Mr. **Mulford**. In the case of Argentina the answer to that question is that we do not expect any program designed to violate those provisions and therefore we don't expect that problem to come up.

Senator **Proxmire**. You don't expect it to come up, but certainly it could.

Mr. **Mulford**. I think in Argentina's case, it's very, very unlikely.

Senator **Proxmire**. Why?

Mr. **Mulford**. Because their figures are rather better than those in a number of other countries and would fall within, for example, the debt service figure which I believe is referred to in one or another of those two provisions.

Senator **Proxmire**. But if it does come up, it would be a conflict of interest situation, would it not?

Mr. **Mulford**. If it were to come up, there would be, I suppose you could argue, a conflict of interest, but probably the effect would be conversations that would take place to insure that it was brought within compliance. I don't think it's a stark conflict of interest which can't be resolved.

Senator **Proxmire**. My time is up, but Senator Riegle has to step out for a minute.

Mr. Dennin, you've been neglected here.

Mr. **Dennin**. That's just fine, Senator.

Senator **Proxmire**. Everything you're doing so far has been perfect so let me see if I can spoil that. I understand that the Latin American debt situation has made it very difficult for those countries to have enough foreign exchange after paying interest on their loans to buy U.S. goods, so our export sales to Latin America and jobs dependent on them have declined dramatically.

EFFECT OF HIGHER INTEREST RATES ON EXPORT SALES

Can you comment on the effect that higher U.S. interest rates will have on future export sales to Latin America?

Mr. DENNIN. Well, obviously, it won't help. The question is: How much higher will they really go and, as some have said, relative to what? If the alternative is inflation going up dramatically, which is a factor that should make interest rates come down, that wouldn't help them either. There are any number of factors that influence export sales and I don't think the increase in U.S. interest rates over the last 2 years is a significant factor in explaining away the massive trade shift with those countries. That's certainly not the reason.

Senator PROXMIRE. It doesn't explain the entire situation, but if interest rates should rise sharply that would certainly create new problems in Latin American nations. Would it not diminish their ability to buy from us and further cut jobs in this country sharply?

Mr. DENNIN. If interest rates increased significantly, it would certainly hurt the ability of those countries further.

Senator PROXMIRE. They are very important trading partners, are they not? Mexico is our third most important trading partner and, of course, the rest of Latin America is important too, not to the same extent maybe, but important.

Mr. DENNIN. Unfortunately, they are much less important than they were 2 years ago because we've had such a dramatic shift. It was one of the fastest growing areas in the world for U.S. exporters. Mexico is still extremely important, although we have had a massive shift there accounting for considerable unemployment, particularly in some areas of the Southwest United States.

Senator PROXMIRE. You mentioned the fact that our exports have dropped to Latin America in recent years. Do you have any predictions on exports over the next 2 years?

I noticed the Secretary of Commerce has predicted that we will have a fierce increase in our adverse balance of trade, up to maybe $100 billion. What do you forecast for Latin America?

Mr. DENNIN. Unfortunately, Senator, there is very little room for optimism in the short term. That's why we feel that it is so important to do everything we can within the acceptable standards of risk. We do not participate in making those judgments, but would speak to the importance of doing what can be done to try to engender a confidence level that will cause not only banks but corporations, for example, to make available the type of trade credit that has traditionally been available. Today we see where corporations are refusing to allow even subsidiaries of theirs in Latin America to have open lines of credit for any reasonable length of time. It's something that is not just a bank problem.

Senator PROXMIRE. Can you tell us whether you expect exports to drop?

Mr. DENNIN. Yes, Senator.

Senator PROXMIRE. Throughout Central and South America?

Mr. **Dennin**. They are not going to maintain the level of decrease which we now see, but they will probably go down overall for the region, although they will get significantly better in some countries like Mexico, some of the more important ones. So when you balance out the few countries in which they may get better against the rest of the region in which they may get worse, it's hard to say how the net will come out.

Senator **Proxmire**. But overall, you expect a continued decline but not as sharp a decline?

Mr. **Dennin**. That's right.

Senator **Hecht**. Senator Riegle.

Senator **Riegle**. Thank you, Mr. Chairman. I think the line of questions that Senator Proxmire was pursuing is very important and he mentioned the dimensions of the trade deficit. Based on last month's numbers, we were running a $120 billion rate and hopefully it will improve, but we've broken through the $100 billion rate and we are now running a $120 billion rate and it's an extraordinary problem because it's unprecedented and the movement is in the wrong direction and, of course, there comes a point at which unemployment in this country will necessarily have to rise again as a result of this.

But I notice that the Commerce Department, just staying on this issue of trade, on April 18, ruled that Brazil and Argentina had been subsidizing their steel exports to the United States and the Commerce Department believes that the ITC should impose penalty duties. So that's going to make it tougher as it properly should for Brazil and Argentina, two of the troubled countries, to sell steel products here in the United States, so you've got that on the one hand, in one action of the Government and the administration, and then at the very same time, within the same period, you've got Bill Brock, our Trade Ambassador, quoted in the New York Times on April 26 as saying, "The ultimate insanity is to think that we can ask others to pay their debts to us at the same time we refuse to buy their products."

So we're again caught in a direct contradiction or Catch-22 and it seems to me that where the policies start to falter is that there are so many contradictions in it, driven by high interest rates which seem to me to really start crippling any effort to have a sustained recovery. It's very hard to have confidence that this program can work over a period of time.

Let me move quickly to two or three other countries and you have been very patient as witnesses and I will try to move through it as quickly as I can.

PERU'S SITUATION WITH THE IMF

I understand from a recent Wall Street Journal article that in the instance of Peru—Peru and the IMF have been negotiating in the 12 weeks since the two sides signed a draft accord on their arrangement, opposition to the IMF terms has been steadily building in Peru. It's been reported that the Finance Minister who negotiated the pact was fired in mid-March, so he's been tossed aside, and a few days later he was a victim of an assassination attempt. Peru's President appears to be backsliding on a belt-tightening program.

He may be watching the Dominican Republic and other places in terms of the unrest. And now the head of the central bank in Peru is openly criticizing the deal as unrealistic.

Without getting into all the ins and outs of the Peru situation, do you have a high degree of confidence that we're going to wrap up the problem with Peru and it will work, or is this now open to question? And I direct this to you, Mr. Mulford.

Mr. MULFORD. Well, we've followed the Peruvian situation very closely, which has involved negotiations between the Government of Peru and the IMF, and I think the facts are approximately as you stated them. But they recently did reach agreement on a program. It's obviously been over the period of negotiation extremely difficult, because Peru has faced a number of unique, special economic problems and political problems which have made it very, very difficult for Peru to come to an agreement on a program which is acceptable to the IMF and still appears to be workable.

Because that has been a very difficult process, my own opinion is that that program is probably relatively fragile and will take a certain amount of dedicated attention on the part of both the Fund and Peru, and I think that's where things stand today.

Senator RIEGLE. Well, put very diplomatically— relatively fragile—I'm not sure what kind of meaning I can attach to that. I gather that you're saying that you don't necessarily have high confidence that this is going to fit together nicely and hold together nicely.

Mr. MULFORD. I have confidence in the program. Yes, I do.

Senator RIEGLE. But not high confidence?

Mr. MULFORD. But I think one can't have as much confidence, for example, there as one has had in other places because of the extreme difficulty in reaching an agreement.

Senator RIEGLE. Well, it's useful for us to hear that. Let's go to Brazil. The former planning minister in Brazil recently wrote an editorial in the New York Times in which he stated, "It is impossible for Brazil under present circumstances to service the debt and maintain an adequate level of economic activity." He concluded, "The only remaining hope is therefore the debtor governments joining together to demand that the interest of their populations be taken into account in this difficult readjustment of the international economy."

Now following the news in Brazil, they had a meeting the other day in the streets and 1 million people came. Something is going on in Brazil as well. Is he right? Is Brazil unable to service its debt in terms of the kinds of internal disciplines that have to be applied in order to meet those debt service requirements?

Mr. MULFORD. I don't believe that he is right. I think that sort of statement is heard very often in slightly different format from a variety of different people in different countries, and it represents part of the agony of the adjustment that has to take place.

Senator RIEGLE. So you think they can do it?

Mr. MULFORD. I believe that Brazil is on the road to recovery and has a program that has a good chance of being sustainable.

DEBT OF POLAND

Senator RIEGLE. Let's go to Poland. Representatives of more than 500 Western banks recently agreed to reschedule $1.9 billion of Polish commercial debt due before the end of 1987. Poland, which has a total foreign debt of about $30 billion, signed three previous rescheduling accords with its bank creditors in 1981, 1982, and 1983. Those payments delayed repaying of some $6.1 billion. The new accord would reach the rescheduling under Poland's medium-term debt.

As I look at this, I ask myself, is there any practical likelihood that Poland is going to start repaying its debt any time soon? Is that in the foreseeable future? If not, why shouldn't they be declared in default if they aren't going to be paying these debts?

Mr. SOLOMON. Well, I think that they comply with the rescheduling terms which provides for some partial interest payment.

Senator RIEGLE. That's a partial interest payment?

Mr. SOLOMON. That's correct.

Senator RIEGLE. Not a repayment?

Mr. SOLOMON. That's right. I think that it's extremely unlikely that in this decade Poland will be able to repay the debt and I don't think that anybody seriously expects that. It is true that ecomomic growth is picking up in Poland now. I don't remember exactly, but I think it was running around 3 percent in 1983 in real terms, as against the declines in growth that they have had. I think there's been some slight improvement in their economic situation.

Senator RIEGLE. But you see no repayments before the end of the decade?

Mr. SOLOMON. I think it would be very unlikely.

Senator RIEGLE. The reason I touch on these others is we're here today about Argentina and the special problems and special arrangements that have been made there, but it's part of the festering set of problems that seem not to be improving in any measurable degree. In fact, I'm concerned particularly with respect to Third World countries that we have been discussing and if the interest rates stay as high as they are or continue to rise as they have been doing in the last 30 to 60 days, we're going to be going into a deeper hole. I'll finish with just two points, Mr. Chairman. I appreciate your patience as well.

On April 7, on the condition of the economy, the Economist reported the involvement of the American banks in Argentina in the following way—not that the economists should be the sole outside judge of the situation, but it's very interesting the way they see it and I want to just quote them:

> The economists said the American banks would have had to record a substantial fall in their profits for the first quarter of 1984 if Argentina had not paid off enough of its interest arrears by March 31 to allow the bands to continue to list the loans on their books as performing ones. So the banks handed Argentina $100 million to hand back to them and persuade the American Treasury and four Latin American countries, all themselves in hock, to put up another $300 million. Before arranging this nonsense, the banks insisted they would stand absolutely firm on making no concession and, if necessary, would declare Argentina's loans nonperforming unless and until Argentina came to terms with the IMF. In saying this and not meaning it, the banks have stored up trouble for themselves. Their 11th hour wiggle has demonstrated publicly to every other debtor country that if negotiations enter the 90-day

deadline will bring better terms out of the American banks and the American Treasury.

Mr. SOLOMON. That's completely inaccurate, sir. You can't flog the argument with a dead horse from both sides. On the one hand, you hear the charge from some elements of the press that the banks gave a concession and therefore Argentina won. On the other hand, you hear exactly the opposite thing. And it just doesn't make any sense.

First of all, as Mr. Mulford has explained very clearly—and he was involved in the negotiations and I was in contact with the Treasury and some of the commercial banks—this initiative did not come from the commercial banks. In fact, when I spoke to the CEO's of a few commercial banks and explained to them this possibility that had arisen due to the Mexican initiative, some of them expressed some misgivings about it. They did not ask for this deal. I can assure you of that. They had reconciled themselves to it. So that part of the article is completely wrong.

Second, I don't understand what they're talking about when they say that concessions were given. I don't know what concessions they're talking about. On a $100 million loan that they made, extremely short term as I explained in my testimony, the Argentine Government has given instructions to the Federal Reserve Bank in New York that if the banks are not repaid from other sources that they will be repaid from Argentine reserves on June 30. So therefore the interest rate charged reflects that kind of security, if you want to use that word.

Senator RIEGLE. But doesn't that mean that the interest rate is somewhat lower than it might otherwise have been?

Mr. SOLOMON. Exactly.

ARGENTINA ACHIEVED A LOWER INTEREST RATE

Senator RIEGLE. So in a sense that's a concessionary interest rate. It's due to these unusual circumstances, but nevertheless, it seems to me what the economists are saying is that by playing hardball and running this thing right down to the wire, Argentina ends up with a better interest rate deal than it would have had otherwise.

Mr. SOLOMON. But I don't think it's fair to say Argentina was playing hardball in that sense. Argentina reserves had improved only very modestly and were still at inadequate levels to make this payment entirely out of reserves and still have enough working capital to continue with its essential imports. It needed this kind of cooperation from the other Latin American countries. So therefore, even though Argentina would have liked to get better terms, as it said many times, on the earlier rescheduling, reopen them, as Mr. Mulford explained, this doesn't mean that they were playing hardball in terms of this situation. In fact, the previous quarter they had drawn on a larger bridge loan in existence in order to make the quarterly payment interest. It was not a question in my view of playing hardball. It was a question of the fact that here they are trying to work out an agreement with the Fund. The economic data base is incredibly bad and even though this sounds like a technical point, it was of enormous importance to the ability to work out an IMF program. They are in the middle of reevaluating policies because President Alfonsin has said that the policy was not working. It was a complicated situation and they have inadequate reserves. So therefore, in a certain sense, there are in human life these kinds of situations and to attribute black and white motivations like playing hardball or not playing hardball doesn't reflect, I think, the situation accurately.

They responded to an offer of cooperation very, very eagerly. They would not have responded to such an offer of cooperation by the other Latin American countries if they were playing hardball because they didn't want anything out of it. They continued doing what they wanted to do, which is basically remain in a nondefault situation while they worked out their new programs.

Senator Riegle. And, of course, we still haven't gotten the thing nailed down. Presuming everything you say is exactly right, we're still struggling with it and we've just slipped one deadline.

Mr. Mulford. Could I just comment on that?

Senator Riegle. Yes. Before you do, I think it's very important that you have the chance to put on the record the full response as you have just done and as you wish to do in response to these comments by the economists.

Mr. Mulford. On the Economist article, I think it's inaccurate. My personal view is I believe it draws the wrong conclusions. It refers to American banks when in fact 1 of the 11 banks was a major British bank which went along and lent part of the $100 million, and I think one has to conclude that the Economist has some sort of problem about Argentina probably related to the Falkland experience and someone went in and lost his objectivity in this particular case.

I would say in reference to the slippage of dates that it's very important in these situations that the ultimate program for adjustment that is agreed is a program which is designed by the governments in question. This takes time. It's a very difficult political operation as we know here in our own country when it comes time to make painful changes. It does take time to work these things out, but it's very important that the country does it itself, that it designs its own program and that it imposes that program on its people rather than to have perhaps for reasons of speed or whatever the impression created that it is the IMF which designs a program and imposes it on a country. We know that that leads to difficulties and I would urge you to consider that we have to be flexible. We have to try to take a longer view of these things in order to make sure that the process is going along in the right way and that the solution reached will be an enduring one and the basis for a more workable adjustment.

Senator Riegle. Well, I may just say that I think Congress has been quite accommodating and this committee has been quite accommodating on a bipartisan basis with the increase in the IMF authorization. I think there's been great patience and in a sense great cooperation, if you will.

The problem is, if the overall policy has in it enormous contradictions having to do with the interest rate levels and trade deficits which are widening rather than receding, and the fact that countries out there seem to be slipping into greater difficulty, there are rising signs of civil unrest in more than one of these countries—the question starts to arise, is each little step on the margin here really relevant in any meaningful way to the overall scale of this problem.

I have to say to you that there's great doubt about that and it isn't just doubt and concern that I have. I hear it from my colleagues on the other side of the aisle which may not have been expressed quite as directly today as some have, but it's a concern that perhaps what we're doing here is not really working our way out of the overall problem, that we're sort of buying time here and buying time there, and in a sense only postponing the day of reckoning that seems to be not very far away.

Mr. **Solomon**. Senator Riegle, may I make a comment on that?

Senator **Riegle**. Yes.

Mr. **Solomon**. I happen to agree with you on the importance of reducing the budgetary deficit to get a lower interest rate impact, but I don't think it's fair to say there's no progress and that it's strictly a patching up situation. There has been some significant improvement in the last 18 months since the first manifestations of the debt crisis.

MODEST ECONOMIC GROWTH THIS YEAR

For example, Mexico, Brazil, I believe Peru, certainly Chile, and Argentina as well, following these adjustment programs are going to have some positive real domestic economic growth this year. That is rather modest, extremely modest. In some cases 1 or 1½ percent. In the case of Argentina it may be, depending on the program, somewhat higher. So in that sense, there's been some improvement.

Second, from the point of view of the U.S. banks, the ratio of their Latin American exposure to primary capital has improved because their capital has strengthened. So that even though they are lending new money, in terms of soundness of the banking system, there has been some improvement in the relationship of their exposure to their primary capital.

Third, these countries in Latin America following adjustment programs are laying a sound basis for a significantly higher growth, in my view, next year because they now are following much more realistic exchange rate policies and reducing their budget deficit and in all cases they are printing less central bank money and the chances of getting some capital flight back are beginning to improve now that they are running a positive real interest rate, and exports are increasing. They're beginning to take advantage of the fact that they have now a more realistic exchange rate.

So I don't feel the situation has not shown improvement, Senator. I certainly think that it's still a very difficult situation and I do agree that significant increases in interest rates complicate that situation even further because it's then much harder to increase their exports that much more in order to get higher prices for their commodities to offset the increase in the interest rates. So therefore, I agree with you that some action on the U.S. budgetary deficit, would reduce the interest rate problem, but I think if you look at the narrowly international area, the present strategy is reasonably comprehensive. It involves a continuation of the IMF adjustment program which will improve the situation in each country in cooperation with new money and rescheduling and a gradual reduction in interest rates, all continuing along as these countries follow adjustment programs.

It is not an ad hoc short-term improvisation. It may look like that, but it represents what I call a medium-term strategy, and the big question will be, once this period is through: Will there be adequate flows of financing so that these countries can return to adequate rates of growth? I think they will be able to return to adequate rates of growth, but they may not be able to return in some cases—you can't generalize too much—to the very high rates of growth they had begun to consider as normal before in the 1970's.

I just mention that point because I think it is important that the record reflect that there has been what, in my view, is significant progress.

Senator RIEGLE. Well, I hope you're right in terms of how you relate that to your view of what the future may hold. The concern that I have is that we went through an incredibly wrenching worldwide recession almost bordering on a depression possibility not all that long ago, and a lot of these countries really went right to the brink during that period of time in terms of their financial condition because of the magnitude of that recession.

Now we have come out of that and had a recovery and the recovery led by the United States and now sort of picked up to a greater extent around the world, but now we are seeing the upward pressure on interest rates; we are seeing the possibility that the same cycle, the same sort of roller coaster cycle, with interest rates and recession, may come at us in a way where inflation is rekindled and we're starting to see that—we're seeing it in housing crisis here and in other yardsticks, and if that continues and interest rates continue to rise, driven in large part too by big fiscal deficits in this country, it seems to me we could find ourselves in a situation where this combination—upward rising inflation, higher interest rates, insufficient credit, if you will—I mean you still have the shortfall on savings rates in this country and other places—and all of a sudden we will find ourselves topping out and heading back into a recession and then suddenly the countries that are beginning to eke out a little bit of progress, as you suggest, in a booming economy or a much stronger economy suddenly find the world economy starts to weaken again and then this whole thing is thrown into reverse gear. And then the ability of those countries to meet IMF requirements and impose the internal disciplines and sort of strap on the sacrifices to their people are going to be even tougher than they are now.

It seems to me that they're pretty tough to do now. It's not clear that they are going to be able to pull that off.

So my concern is if we could assume that we are never going to have another recession or if we assume that we're never going to have a high interest rate condition or credit shortage problem that turns the economy around out there in 6, 9, 12, or 18 months, you might well be right. But my apprehensions lie in that area and they are not just mine. The financial markets feel the same way.

That's why we are seeing these extraordinary high real interest rates being demanded.

I will just finish by saying in reference to the conversation I had before that I couldn't follow through with the chairman of the committee, the Senator from Georgia, interest rates back in 1980 were much higher, nominal rates were much higher. They got up to the 18- to 20-percent range. And of course the inflation rates were much higher at that time and there was a bad condition. It drove out a sitting President probably as much as anything else. And now we're in a situation where we have a stronger economy, massive deficits, interest rates have come down in nominal levels, but inflation has dropped even faster. So that now we still have real interest rates, which the three of you certainly understand, that are as high, if not higher, than they were 4 years ago or 3 years ago. So that that would seem to suggest that in the view of creditors and those that have capital to make available that they still feel they've got to have that spread in terms of a premium over and above the inflation rate at an extraordinarily high level. It makes me feel that they don't have confidence in the future. You've got 1,000 basis points over and above the inflation rate and actual rates of interest. I mean, that really takes my breath away and just causes me to say, if everything is as great as you're saying, why aren't the financial markets believing it? Why are we seeing these things?

Mr. SOLOMON. I wouldn't want to get into a discussion with you on that aspect because I've got a lot of sympathy for your position, but what I was saying is it's not quite fair to say in the case of the highly indebted countries that there's been no improvement in the situation. That is the narrower point that I was going on record on.

Senator RIEGLE. Well, if you're correct in that notion, and I hope you are, as I say, the Congress has been willing to facilitate that possibility by making the legislative decisions to increase the IMF authorization and so forth so that we can pursue the strategy and try to make it work. But if the larger picture where you say you share the concern is not managed properly, it seems to me we're going to be overtaken by those realities in a way that the dimensions of that scale of the problem dwarf these other things and no matter how hard Peru, Argentina, or Brazil tries, or Mexico or anybody else, they are not going to be able to swim against that kind of tide if that's what we're going to be facing down the road here.

So I would hope we could find a way to reconcile the overall policies so that that's not the thing we find because we could be thrown in to a kind of chaos that goes way beyond anything we've seen yet.

I want to thank you for your patience and for the completeness of the responses you have given to the committee.

Senator HECHT. There will be additional questions for the record which each of you will probably have to respond to at a later date.

The committee is adjourned.

[Whereupon, at 12:15 p.m., the hearing was adjourned.]

[Response to written questions follows:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ
FROM
DAVID C. MULFORD, ASSISTANT SECRETARY INTERNATIONAL
AFFAIRS, DEPARTMENT OF THE TREASURY

QUESTIONS ON ARGENTINE DEBT

I. THE ROLE OF U.S. BANKS

Question:

1. Isn't it true that the banks have received some guarantees of repayment? It has been alleged that they have, and if this is so, isn't this one more case of the LDCs having a worse deal than the banks? I have heard that the banks are really quite certain of repayment.

Answer:

As part of the arrangement, the Argentine Government agreed that it would repay the eleven commercial banks in the lending group $100 million upon the completion of pending lending arrangements with a large syndicate of banks. If those lending arrangements are not completed by June 30, the Argentine Government has agreed to repay the banks from Argentine deposits held at the Federal Reserve Bank of New York. Repayment of the banks is contemplated, under the arrangement, from additional bank financing. In contrast, the four Latin American Governments participating in the financing package have not agreed to provide additional financing.

II. U.S. RISK IN THE ARGENTINE LOAN

Question:

1. Since the U.S. has agreed to lend Argentina a total of $300 million, is it not safe to say that the U.S. is at risk in this operation? It is rare to hear of a totally riskless loan, and I frankly find it hard to accept this loan as riskless.

Answer:

The Treasury, through the Exchange Stabilization Fund, has agreed to lend $300 million to Argentina only after Argentina has signed an agreed "Letter of Intent" with the IMF. Based on this Letter of Intent, the IMF Executive Board then takes formal action in approving a standby arrangement for Argentina, under which Argentina will be eligible immediately to make drawings from the IMF. Argentina is required to repay the Treasury when Argentina makes its initial drawings under the IMF standby arrangement. Under normal IMF procedures, formal approval of the Argentine standby program by the IMF Executive Board may be expected within 30-60 days following Argentine signature of the Letter of Intent.

However, Executive Board action is contingent on agreement between Argentina and its creditor banks on a new money package, which involves several complicated issues. Thus, there is a some risk that formal Board approval -- following signature of the Letter of Intent -- could be considerably delayed or even withheld.

This, in turn, creates a risk that Argentina would be unable to make drawings from the IMF with which to finance repayment to the Treasury. Thus, ultimately, there is a limited risk associated with repayment of the contemplated ESF financing.

Question:

2. What is the record of LDC's compliance with the IMF as far as paying back loans?

Answer:

The record of IMF members meeting their repayment obligations is generally excellent. No country has ever defaulted on its financial obligations to the Fund.* However, arrears on payments to the IMF have increased in recent years due to the severe balance of payments problems experienced by some members, although the amount remains quite small. In 1983, payments overdue for more than six weeks amounted to under one half of one percent of total payments due to the IMF. In all cases to date (except as indicated in the footnote) these arrears have been cleared up.

* Cuba withdrew from the Fund in 1964 after a dispute over payments but subsequently repaid its obligations. Kampuchea currently has outstanding IMF obligations and has not communicated with the Fund since 1975.

Question:

3. Could you clarify whether the U.S. guaranteed the other loans made to Argentina by the Latin American countries -- Mexico, Brazil, Venezuela, and Colombia -- and the commercial banks. It has been said that the U.S. may have made some sort of a guarantee either to the LDCs or the banks, in order to assure the sucess of the bridge package?

Answer:

The U.S. government has not provided any guarantee of repayment to any participant in the financial package for Argentina, including four Latin American governments or the banks. When Argentina signs a "Letter of Intent" with the IMF, Treasury has agreed to lend $300 million to Argentina. Argentina, in turn, would apply the proceeds from this loan to repay the four Latin American governments. Should Argentina not reach agreement with the IMF on a Letter of Intent and, therefore, should the U.S. not lend Argentina $300 million, Argentina is committed to good faith negotiations with the four Latin nations to determine the means of repayment, such as through trade with Argentina. The Federal Reserve did not in any way guarantee any element of the package; it participated solely as agent, receiving the money of the various lenders and transferring it at the appropriate time to the agent bank responsible for the distribution of the interest payments.

III. USE OF THE EXCHANGE STABILIZATION FUND FOR THIS TRANSACTION

Question:

1. I have heard it alleged that the fund that was used to finance the U.S. loan to Argentina, the Exchange Stabilization Fund, was improperly used in this case. Is this so? What is the purpose of the ESF, and is this loan within the statutory guidelines for the use of the Fund?

Answer:

The ESF has not been used improperly in the case of the Treasury commitment to Argentina; the commitment has clearly been within all guidelines.

The ESF was established by the Gold Reserve Act of 1934, which originally provided the following:

> For the purpose of stabilizing the exchange value of the dollar, the Secretary of the Treasury, with the approval of the President, directly or through such agencies as he may designate, is authorized, for the account of the fund established in this section to deal in gold and foreign exchange and such other instruments of credit and securities as he may deem necessary to carry out the purpose of this section.... (P.L. 73-87, Section 10 of the Gold Reserve Act of 1934)

With the termination of the fixed exchange rate system and the 1978 amendments to the IMF Articles of Agreement, the ESF was amended in 1976 (effective 1978) and 1977. For example, the provision "for the purpose of stabilizing the exchange value of the dollar" was dropped. The statue now provides as follows:

> Consistent with the obligations of the Government in the International Monetary Fund on orderly exchange arrangements and a stable system of exchange rates, the Secretary or an agency designated by the Secretary, with the approval of the President, may deal in gold, foreign exchange, and other instruments of credit and securities the Secretary considers necessary. However, a loan or credit to a foreign entity or government of a foreign country may be made for more than 6 months in any 12-month period only if the President gives Congress a written statement that unique or emergency circumstances require the loan or credit be for more than 6 months. (31 U.S.C. 5302(b))

The language, "consistent with the obligations of the Government in the International Monetary Fund on orderly exchange arrangements and a stable system of exchange rates," was inserted in order to conform the purpose of the ESF to the revised IMF Articles and to clarify that "the ESF is to be used only for purposes consistent with U.S. obligations in the IMF." (Senate Report 94-1295, 94th Congress, 2nd Session, June 22, 1976, p.17)

The obligations of each member of the International Monetary Fund (IMF), as set forth in Article IV of the Articles of Agreement, include commitments to:

(1) endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;

(2) seek to promote stability by fostering orderly under lying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions;

(3) avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members; and

(4) follow exchange policies compatible with the undertakings under this Section.

The legislative history of the Gold Reserve Act and of its amendments indicates clearly that the intent of the Congress was that ESF financing may specifically include loans or credits to foreign governments. This intent was reaffirmed by the 1977 amendment, which placed limitations on the terms of the financing that the Secretary is authorized to extend to foreign countries. The legislative history indicates that the intention of the Congress was to assure that ESF credits are short-term and used to support the role of the International Monetary Fund as the principal source of official balance of payments financing:

> In order to insure that ESF lending operations are not inconsistent with the goals of the IMF, the Committee has adopted an amendment emphasizing the intended short-term nature of ESF lending. The goal is for the United States to place primary reliance on the IMF and to confine foreign exchange lending operations outside the IMF to short-term operations. Under the amendment, the ESF would be barred from extending loans to a foreign government for more than six months in any twelve month period ... unless the President provides a written determination.... (Senate Report 94-1295, 94th Congress, 2nd Session, September 22, 1976, p 11; see also House Report 94-1284, 94th Congress, 2nd Session, June 21, 1976.)

Since late 1982, ESF short-term financing has been one element of the U.S. strategy for dealing with the problems of international indebtedness, which has posed a major threat to the international monetary system. This strategy, which was endorsed by the major industrial countries at the 1983 Williamsburg Summit and was recently reaffirmed by the London Economic Summit, includes:

(1) economic adjustment by the debtor countries;

(2) IMF assistance in support of effective adjustment programs;

(3) temporary short-term government and central bank bridge financing in selected cases;

(4) continued commercial bank lending; and

(5) sustained world economic growth with open markets.

The third element in the overall strategy, noted above, is for governments and central banks to act quickly to provide short-term financing where needed in exceptional situations to support a country's adjustment efforts. Problems may arise rapidly, and financing may be needed immediately to enable debtor countries to have the time to negotiate agreements with the IMF. We are undertaking this, where necessary, on a case-by-case basis, through arrangements often involving financing by other countries.

The current ESF arrangement with Argentina is an important instance of the implementation of our debt strategy. Under this arrangement, the ESF's resources cannot be drawn until Argentina agrees on a letter of intent with the IMF for a new adjustment program. In making the commitment, our objective has been to join other parties, including Latin American governments and the banks, in supporting Argentina's adjustment efforts, thereby strengthening the operations of the international monetary system. This objective is certainly consistent with U.S. obligations in the International Monetary Fund regarding "orderly exchange arrangements and a stable system of exchange rates."

Accordingly, both the statute and the legislative history of the ESF fully support the actions taken by the Treasury with respect to the swap agreement with Argentina.

Question:

2. Where does the financing for the ESF come from? In other words, is the U.S. taxpayer just loaning out more dollars to another LDC? Will this cause the U.S. Government to incur an even greater deficit, at a time when we can hardly afford to do so?

Answer:

The ESF credit to Argentina would be financed from ESF dollar resources. While ESF resources "belong" to the U.S. taxpayer, ESF transactions are not budgetary expenditures, do not increase the budget deficit, and at present are conducted without cost to the taxpayer. The net realized profits or losses of the ESF are recorded in the Federal budget, and in fiscal year 1983 the ESF realized profits of $517.6 million.

IV. COOPERATION OF LATIN AMERICAN NATIONS WITH ARGENTINA

Question:

1. I find it amazing that four Latin American nations, all of whom are facing debt problems in varying degrees, have decided to loan money to Argentina. Mexico is just beginning to make economic progress, Brazil may face a crisis soon, and both Colombia and Venezuela are facing. adjustment problems. Did the U.S. play a role in suggesting the four-nation loan to Mexico, who was apparently the leader of these four nations in this arrangement?

   How is it possible that these four countries could come up with the funding necessary to loan Argentina these amounts? All we hear about is the desperate shape their economies are in, and how reschedulings will occur for virtually all the LDC debtor nations. How could they afford this?

Answer:

The initiative for the $300 million four-nation Latin American loan to Argentina originated with Mexican Finance Minister Silva Herzog. After having consulted with officials from the other Latin American nations, Silva Herzog proposed the arrangement to Argentine officials before asking the U.S. to participate as a lender.

While the four Latin American governments face varying degrees of cash-flow difficulties, it was their collective judgment that avoidance of a serious decline in Argentina's creditworthiness was important to ensuring their continued access to bank credits. This concern outweighed the temporary decline in reserves which they have experienced by lending $300 million to Argentina.

Question:

2. Do these nations have any guarantee that they will be repaid? We know that the risk to the U.S. is minimal, and you have also made it clear that the U.S. did not guarantee the loans of these four nations. What is their risk?

Answer:

The agreements governing the March 30 financial package for Argentina contains no guarantees of repayment for the four Latin nations that participated in the package. However, when Argentina signs a letter of intent with the International Monetary Fund, the U.S. will lend Argentina $300 million on a short-term basis, and those funds will be used to repay the four Latin nations. (The U.S. will be repaid from the funds Argentina receives from the IMF following Board approval of the new stand-by arrangement.) Should the loans not otherwise be repaid, Argentina is committed to good faith negotiations with the four Latin nations to determine the means of repayment, such as through trade with Argentina.

V. MISCELLANEOUS QUESTIONS

Question:

1. An international banker has been loosely quoted as saying, in reference to the Argentinian debt negotiations, "democracy should be worth 1/2 a point." Is this a statement you can support, and if so, what role did this thinking play in the debt negotiations?

Answer:

We believe that the terms of loans are a matter to be decided between borrowers and lenders. It is logical to expect that progress toward improved creditworthiness will be reflected in more favorable terms for the borrower, as has been demonstrated by the experience of Mexico. One can argue that in the long run a democratic environment in Argentina is more conducive to the stable economic growth that is the essential element of creditworthiness. Once that improvement occurs, better terms can be expected.

Question.

2. It has been asserted that all debt negotiations are in some way political. Yet, the loans being negotiated are from commercial banks, and were made on a commercial basis. Should the U.S. Government ask banks to support a new democracy because it is in the political interest of the U.S. without being willing to provide some financial support to these negotiations? If the package fails to solve the immediate problems, will the government be forced to support the banks financially?

   Since bank loans are closely tied to a delicate political situation, in which we have a significant foreign policy interest, should the U.S. government monitor bank lending more closely and provide more guidance to U.S. banks renegotiating the Argentine (and other Latin) debt?

Answer:

U.S. policy is to leave commercial decisions to private lenders, subject only to prudential oversight and rare cases such as those where actions are taken under the International Emergency Economic Powers Act (PL 95-223). One basic reason for this position, as suggested by the final part of this question, is that intervention with the lenders in order to achieve foreign policy objectives would imply a responsibility on the part of the U.S.G. in the event of non-payment. We believe most members of the banking community recognize that continued involvement in lending to countries undertaking adjustment is in the interest of both parties.

Since the advent of significant debt servicing difficulties, we have intensified our monitoring of bank lending to developing countries. Recent changes in reporting requirements will be increasing the amount of data available on the U.S. banks activities, and improvements in information on lending banks from other countries' banks are also under way. As noted, we do not intervene in negotiations between borrowers and lenders.

Question:

3. Are U.S. interests best served by allowing banks to make loans purely on a commercial basis, when this basis may draw them to favor stable one-party states over growing democracies? For instance, it has been said that banks prefer a military government in Poland to a more liberal development in that country, since a military government is more likely to pay its debt?

Answer:

Banks make loans on the basis of commercial judgements. It is reasonable to assume that banks prefer stable lending environments, but their primary concern is a country's ability to generate foreign exchange needed to service external debt, not the form of its government.

Question:

4. What will happen if an agreement is not reached, and Argentina does not pay its next quarterly interest payments? This is still a possibility, and I think the consequences should be made clear to everyone?

Answer:

Banks must place the interest on loans on a nonaccrual basis if interest payments or principal repayments are more than 90 days in arrears and are not well secured or in the process of collection. Nonaccrual status means that interest cannot be accrued, when due but not yet paid, that it can be recorded only on a cash basis when received, and that previously accrued but unpaid interest be reversed from income. If this occurs, then it is likely that regulators would classify the loans as "substandard". This will have a negative impact on Argentina's ability to borrow from the financial markets. At present, Argentina and the banks are negotiating an interim financing package which would enable Argentina to pay interest on public sector debt to commercial banks through April 2 and, thus, avert a payments crisis through the second quarter.

Question:

5. Many Latin American nations, particularly Argentina, Mexico and Brazil, are in a very difficult debt situation. So far, we have been able to arrange adjustments and reschedulings when they become necessary. How long can this go on? Are these nations merely facing a lack of liquidity, momentarily unable to keep up with their debts, or are their economies basically unsound and insolvent? Will their economies ever recover?

Answer:

We believe that the U.S. government's strategy for dealing with the problems of international indebtedness will continue to provide a viable and pragmatic basis for dealing with the problems of individual debtors. The central element of the strategy is that debtor countries adopt comprehensive, credible, and effective programs for strengthening their balance of payments and stabilizing their economies. The overwhelming majority of debtor nations have, in fact, made substantial progress in their adjustment efforts, indicating that their problems are surmountable and that they can return to a sustainable growth rate. For example, Mexico confronted a serious liquidity crisis in August 1982, but since then has implemented a sound economic program, laying the basis for a restoration of stable economic growth. Mexico's success in its adjustment efforts is reflected in a substantial improvement in its balance of payments situation and a reduction in its external borrowing requirements. In early June, Mexico's major commercial creditors indicated their willingness to negotiate a multi-year rescheduling in view of the progress that Mexico had made toward adjustment.

Question:

6. What needs to happen both in their economies and in the international economy before they can really get out of their present situation? Are we waiting for an impossible improvement, or can we really imagine the circumstances sufficient to allow their recovery?

Answer:

In order to alleviate further difficult economic conditions within Latin America the governments must maintain their commitment to policies that reduce internal imbalances commonly associated with excessive government spending and price controls. The policies should also further encourage domestic and foreign investment and make domestic production more competitive in international markets. Industrial countries, in turn, must keep their markets open to less developed countries. At the same time, recovery in the industrial world, led by the strong U.S. economy, should continue. Creditor banks should also provide continued commercial bank lending for those countries making further progress in their adjustment efforts. If the above conditions are satisfied, and most of them are, it is likely that Latin American countries will experience additional recovery.

Question:

7. It is known that Argentina placed a higher priority on paying trade obligations than interest payments in the months leading to the negotiations. In your view, would the Argentine situation be more positive, both for the banks and Argentina, if a trade credit insulation program was in effect during the period? Please explain the likely effect?

Answer:

A commercial trade credit insulation program under which trade credits to creditor banks are not rescheduled is clearly in Argentina's interest. Rescheduling of trade credits (which are typically very short-term maturities) would undermine established trade finance arrangements (particularly letters of credit for specific exports to Argentina) and severely constrain the ability of Argentina to import goods. The impact of rescheduling open line suppliers' credits would depend upon the arrangements reached with individual suppliers. However, in some extreme cases, rescheduling of trade credits is considered necessary by the debtor country and its external creditors.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE
FROM
DAVID C. MULFORD, ASSISTANT SECRETARY INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY

Question:

1. You have described in your testimony the very adverse blow to the international financial system that was averted by the action taken at the end of March to provide $300 million to Argentina so it could pay the interest on existingloans. Can you tell us whether the Federal Reserve or the Treasury Department took the lead in arranging the agreements to aid Argentina?

Answer:

The initiative for the $300 million four-nation Latin American loan to Argentina originated with Mexican Finance Minister Silva Herzog. After having consulted with officials from the other Latin American nations, Silva Herzog proposed the arrangement to Argentine officials before asking the U.S. to participate as a lender. At a certain point in the negotiations, Treasury agreed to lend $300 million to Argentina from the Exchange Stabilization Fund, after Argentina reaches agreement with the IMF on an adjustment program. Treasury, with the support of the Fed, also played a role in facilitating the final formulation and implementation of the package. The Federal Reserve participated as an agent for the multilateral facility, receiving the money of the various lenders and transferring it at the appropriate time to the agent bank responsible for the distribution of interest payments.

Question:

2. Can you also tell us why if this matter was so important we did nothing until Mexico and the other Latin nations took the lead? Or were those countries prompted by the Federal Reserve or Treasury to suggest that action be taken to aid Argentina?

Answer:

Treasury was motivated to participate in the Argentine package by the desire to support the new democratic government of Argentina and to help insure a continued and effective functioning of the international monetary system. Treasury was concerned that Argentina's failure to pay interest arrears by March 31 could pose a significant threat to its creditworthiness and its ability to restore a sound economy. However, we made the judgment early in March that the earnings penalties that might be suffered by U.S. banks were sustainable without a threat to the system. At the same time, several Latin American countries had begun to be concerned about the adverse effect of a serious decline in Argentina's creditworthiness on their own financing prospects. The actions taken by the Treasury and the Federal Reserve were in response to the initiative proposed by the four Latin American nations.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE
FROM
DAVID C. MULFORD, ASSISTANT SECRETARY INTERNATIONAL
AFFAIRS, DEPARTMENT OF THE TREASURY

Question:

1. Michigan is now entering its 52nd consecutive month of double-digit unemployment and I am continually confronted by the very legitimate and same question from frustrated constituents: Why are American banks lending abroad to the extent that they are, rather than focusing their lending here at home? What is your response?

Answer:

Any attempt to redirect lending from foreign to domestic customers would require interference by the government and probably result in controls on capital flows abroad that would have negative effects for all bank lending, including domestic. Moreover, there is little scope for substitution by the banking sector between foreign and domestic lending, since the volume of domestic lending is largely determined by domestic monetary policy.

Question:

2. How long do you believe Argentina can continue devoting two-thirds of its annual export earnings and 8 percent of total value of its goods and services to pay interest on its bank loans?

Answer:

Argentina's total gross interest payments on its external debt accounted for an estimated 58% of export earnings and 9% of the value of goods and services in 1983. Argentina's interest payments to banks in the countries reporting data to the Bank for International Settlements in 1983 stood at an estimated 34% of export earnings. Recent rises in international interest rates have exacerbated Argentina's heavy debt-service burden. Nevertheless, it is in Argentina's interest to avoid arrears on interest payments to bank creditors in order to assure access to new commercial credits. Moreover, implementation and adherence to an IMF-supported adjustment program will substantially bolster Argentina's domestic output and export performance over the medium-term and thus lessen the relative share of export earnings applied to debt-service.

Question:

3. A number of bankers say U.S. banks are likely to face another crisis at the end of the second quarter when Argentina can't pay overdue interest and the banks have to reduce their quarterly earnings. What is your response?

Answer:

If agreements are not in place with the IMF and with private creditors at the end of the second quarter, it is likely that a substantial portion of loans to Argentina would be placed on nonaccrual status. This would result in moderate reductions in earnings for many large U.S. banks -- the precise percentage would vary fairly widely.

Question:

4. A number of commentators, including the President of West Germany's Bundesbank, Karl Otto Poehl, suggest that the next steps in the "adjustment process" regarding easing of the world debt problem should be up to the banks -- to offer debtors many concessions permitting easier repayment terms. Do you agree, and if so, what steps do you think banks ought to be taking?

Answer:

There may be cases where it would be appropriate to reduce interest rate spreads, grant longer maturities and grace periods, or take other steps which reduce the debt servicing burden. This issue will be decided in private negotiations between debtors and creditors based upon perceptions of a debtor's creditworthiness and progress in making economic adjustment. It is not possible to generalize; every case is different. Mexico provides an example of an country which has implemented a successful adjustment program and, thus, is being considered for a multi-year rescheduling; lower interest rate spreads on a 1985 new money facility may also be considered.

It is important that debtor countries not be given disincentives to necessary economic adjustment and that the ability of debtors to raise new money not be impaired; this could be the result if easier terms were offered in the absence of significant adjustment and progress by the debtors themselves, because some creditors would see no reason to enter new money facilities.

Question:

5. The editors of the Wall Street Journal have periodically and dutifully reported the debt crises in Mexico, Brazil, and Argentina and have suggested, along with the free-market conservatives, that the international banking community should simply be forced to write down or write off their debt, let bank stockholders and executives take the loss, and soldier on -- sadder, smarter, and leaner. What is the problem with this approach?

Answer:

Banks should value their assets realistically. However, we are opposed to "forced" writeoffs as a means of "solving" debt problems. Those problems can only be resolved through a combination of adjustment by borrowers and appropriate amounts of financing in support of the adjustment process. The regulators, through the recently instituted Allocated Transfer Risk Reserves, in effect have mandated the write down of capital equal to particular percentages of banks' loans to specific protracted problem debtors. However, each case must be considered on its merits and reviewed periodically. We believe that more generalized, forced writeoffs would discourage banks from participating in reschedulings and new money arrangements, and thus be more likely to hinder than help the process.

Question:

6. To many of us, it is becoming clear that after repeated Latin American debt reschedulings such quick-fix arrangements don't begin to solve the region's long-term economic problems.

   What do you see as acceptable alternatives?

   Do current growth and interest rate projections provide reason for optimism that the current debt crisis is solvable?

Answer:

Debt reschedulings represent merely one element of the over-all U.S. government's 5-point strategy for dealing with problems of international indebtedness. The central element of the strategy is that debtor countries adopt comprehensive, credible and effective programs for strengthening their balance of payments and stabilizing their economies. Generally these are policies which encourage investment and make domestic production more competitive in international markets. Another element of the U.S. government strategy is that industrial countries should follow policies leading to sustainable, non-inflationary growth in the industrial world. Current assumptions for medium-term growth and interest rates among OECD nations provide the grounds for a resurgence of the exports from many debtors and imply little rise in interest rates.

Question:

7. By common agreement the biggest threat at the moment to easing the world debt problem, at least for now, is the spectre of rising interest rates. According to a number of international officials, a sharp increase in debt-service costs quickly could undo any progress that's been achieved -- a prospect far more worrying than the doomsday predictions of 1982.

   What would be the effect on the world debt problem of various incremental increases in interest rates?

Answer:

Any incremental increase in international interest rates would obviously require that debtor nations devote a larger share of export earnings and national product to external debt-service. However, to the extent this increase in interest rates reflects higher-than-expected growth rates, debtor countries will receive an offsetting benefit form higher export earnings.

Question:

8. To what extent are trade restrictions by industrial countries already impeding borrowing countries' efforts to sell their exports?

Answer:

Industrial country markets are generally quite open to exports from high-debt LDC's. The United States is the fastest-growing market for Latin American exports. U.S. economic growth spurred a $2.8 billion (or 16%) increase in U.S. non-oil imports from Latin America in 1983. In contrast, Latin American exports to all other destinations grew by about one percent. As testimony to our strong recovery in the first quarter of 1984, U.S. imports from the six key Latin debtors increased by a dramatic 30%.

Industrialized countries do, however, maintain significant non-tariff trade barriers in the agricultural, textile, and steel sectors. For example, the United States maintains import quotas on some agricultural products which affect debt-burdened countries (primarily sugar), has bilateral quota agreements on textiles with several high debt LDCs, and has restricted specialty steel imports from Brazil, Argentina and Mexico. The EC has even broader agricultural restrictions (including a variable levy system which erases any competitive price advangage), comparable textile restrictions, and bilateral export restraints on carbon steel.

For most other manufactured products, however, the U.S. market remains open. The restrictions above accounted for less than $800 million in U.S. imports from Latin American countries in 1982, as compared to total U.S. imports from these countries of $27.2 billion, i.e., a very small portion of the total.

U.S. countervailing and antidumping duties (or export taxes by the exporting countries in some cases) were applied to an additional $1 billion in U.S. imports from these countries in 1982. These are not "protectionist" measures, but merely offset the artificial price advantage granted by the exporting countries.

The major factors affecting export earnings for Argentina, Chile, and Peru between 1980 and 1982 were the general world recession and the general decline in commodity prices, which have now regained about half of the nearly 30 percent decline in that period.

U.S. and OECD economic growth will be the major factors assisting borrowing countries' export earnings in 1984. Further increases in commodity prices, although perhaps less than in previous recoveries, will also help.

Question:

9. Which debtor countries, if any, are currently under significant domestic pressure to ease or discontinue their austerity programs?

Answer

Countries with IMF arrangements realize that the IMF programs are essential to the resumption of sustainable economic recovery. They understand that this often requires sacrifices that can lead to social unrest. The problem is not with the IMF programs but in the fact that most of the actions required by the IMF have often been delayed too long.

FEDERAL RESERVE BANK OF NEW YORK

Anthony M. Solomon
President

COPY

May 23, 1984

The Honorable John Heinz
United States Senate
Committee on Banking, Housing, and
Urban Affairs
Washington, D.C. 20510

Dear Jack:

I am enclosing responses to the questions you raised on the Argentine debt financing package sent to me by Mr. Paul Freedenberg in a letter dated May 14.

Please call me if you would like to discuss the issues further.

With best regards,

Sincerely,

(Signed) Tony

Attachment

cc: Mr. Ed Malan, Editor
Committee on Banking, Housing,
and Urban Affairs

RESPONSE TO SUPPLEMENTAL QUESTIONS
BY SENATOR HEINZ

I. THE ROLE OF U.S. BANKS

1. Isn't it true that the banks have received some guarantee of repayment? It has been alleged that they have, and if this is so, isn't this one more case of the LDCs having a worse deal than the banks? I have heard that the banks are really quite certain of repayment.

The banks are assured by the Argentine Government's instructions to the Federal Reserve Bank of New York, of repayment by June 30 but only with respect to $100 million of additional loans made by the 11 banks to Argentina at the end of March. This compares to some $8.4 billion owed by Argentina to U.S. banks whose terms are likely to be renegotiated after an IMF program has been approved for Argentina. Argentina benefitted from the $100 million provided by the banks--it was not a case of their receiving a "worse deal" than the banks.

II. U.S. RISK IN THE ARGENTINE LOAN

1. Since the U.S. has agreed to lend Argentina a total of $300 million, is it not safe to say that the U.S. is a at risk in this operation? It is rare to hear of a totally riskless loan, and I frankly find it hard to accept this loan as riskless.

At present no U.S. Government funds have been paid out. When the IMF letter of intent is signed, the U.S. will lend $300 million, and it will be at risk--a risk I consider very small--until the IMF Executive Board formally votes to approve the Argentine program. This approval will release the Fund money which Argentina will use to repay the U.S. Treasury. Normally, it takes 30 to 60 days after the letter of intent is signed for the Executive Board to act.

2. What is the record of LDCs' compliance with the IMF as far as paying back loans.

   (Assistant Secretary Mulford was to follow up on this question for the House [see page 88 of that testimony])

3. Could you clarify whether the U.S. guaranteed the other loans made to Argentina by the Latin American countries--Mexico, Brazil, Venezuela, and Colombia--and the commercial banks. It has been said that the U.S. may have made some sort of guarantee either to the LDCs or the banks, in order to assure the success of the bridge package.

   Neither the United States nor the Federal Reserve System guaranteed the loans made to Argentina by the Latin American countries and the commercial banks.

III. USE OF THE EXCHANGE STABILIZATION FUND FOR THIS TRANSACTION

1. I have heard it alleged that the fund that was used to finance the U.S. loan to Argentina, the Exchange Stabilization Fund, was improperly used in this case. Is this so? What is the purpose of the ESF, and is this loan within the statutory guidelines for the use of the Fund?

   The ESF was used properly. In this case, U.S. Government financing, through the Treasury's ESF, is to be available on a temporary basis for one essential purpose--to encourage agreement between Argentina and the IMF on an adjustment program. That is in conformance both with U.S. law, which calls for the ESF to be used to support U.S. objectives in the IMF, and with past practice. Similar bridging loans have played essential roles in adjustment efforts, for example, for Mexico and Brazil.

2. Where does the financing for the ESF come from? In other words, is the U.S. taxpayer just loaning out more dollars to another LDC? Will this cause the U.S. Government to incur an even greater deficit, at a time when we can hardly afford to do so?

   The original funds of the ESF were appropriated from the revaluation of U.S. gold stock in the early 1930s. ESF currency transactions such as the currency swap with Argentina are not appropriated by the Congress and are not budgetary expenditures but rather are recognized as monetary operations. The interest charged by the ESF on such transactions covers the cost of the ESF financing. At the end of each fiscal year, the net realized profits or losses of the ESF are recorded in the federal budget. In fiscal year 1983, the ESF realized a net income of $517.6 million.

IV. COOPERATION OF LATIN AMERICAN NATIONS WITH ARGENTINA

1. I find it amazing that four Latin American nations, all of whom are facing debt problems in varying degrees, have decided to loan money to Argentina. Mexico is just beginning to make economic progress, Brazil may face a crisis soon, and both Colombia and Venezuela are facing adjustment problems. Did the U.S. play a role in suggesting the four-nation loan to Mexico, who was apparently the leader of these four nations in this arrangement?

   For a short period of time those countries are able to make relatively modest sums available to Argentina. Mexico has increased its reserves significantly as a result of its successful adjustment program, and Brazil is beginning to improve its reserves. Venezuela and Colombia have reserves. The initiative for this proposal came from the Mexican government.

2. Do these nations have any guarantee that they will be repaid? We know that the risk to the U.S. is minimal, and you have also made it clear that the U.S. did not guarantee the loans of these four nations. What is their risk?

   If there is no letter of intent reached with the IMF, then those countries would look directly to Argentina to be repaid.

MISCELLANEOUS QUESTIONS

1. An international banker has been loosely quoted as saying, in reference to the Argentinian debt negotiations, "democracy should be worth 1/2 a point." Is this a statement you can support, and if so, what role did this thinking play in the debt negotiations?

   The terms and conditions are a matter for negotiation between the lenders and the borrowing countries.

2. It has been asserted that all debt negotiations are in some way political. Yet, the loans being negotiated are from commercial banks, and were made on a commercial basis. Should the U.S. Government ask banks to support a new democracy because it is in the political interest of the U.S., without being willing to provide some financial support to these negotiations?
   If the package fails to solve the immediate problem, will the government be forced to support the banks financially?

3. Are U.S. interests best served by allowing banks to make loans purely on a commercial basis, when this basis may draw them to favor stable one-party states over growing democracies? For instance, it has been said that banks prefer a military government in Poland to a more liberal development in that country, since a military government is more likely to pay its debt?

   Yes, politics will play some part in international lending decisions. However, the U.S. Government should not direct individual banks to lend for political purposes. Better economic decisions will be made if banks continue to make loan decisions on a commercial basis. If it is in the national interest for the United States to support certain debtor countries, the United States should provide such financial assistance directly to those countries. One has to remember that, while these hearings have focused on Latin American debt owed to U.S. banks, the majority of international lending by U.S. banks is to democratic industrial countries.

4. What will happen if an agreement is not reached, and Argentina does not pay its next quarterly interest payments? This is still a possibility, and I think the consequences should be made clear to everyone.

   It is of course possible that agreement between the IMF and Argentina will not be reached by June 30. What happens then depends on how significant such an event is perceived in the overall negotiations and the circumstances at the time--for example, whether the remaining obstacles result from technicalities or from more fundamental problems.

5. Many Latin American nations, particularly Argentina, Mexico, and Brazil, are in a very difficult debt situation. So far, we have been able to arrange adjustments and reschedulings when they become necessary. How long can this go on? Are these nations merely facing a lack of liquidity, momentarily unable to keep up with their debts, or are their economies basically unsound and insolvent? Will their economies ever recover?

Many Latin American countries are in a very difficult debt situation, but they have begun to take the steps necessary to restore their economies to reasonable rates of growth while meeting their debt obligations. Some countries, like Mexico, have made more progress in their adjustment than others. Absent another world economic shock such as that caused by major oil price changes, and with realistic adjustment programs, the economies of debtor countries can recover, though most probably not to the high rates of growth they experienced in the 1970s and early 1980s.

6. What needs to happen both in their economies and in the international economy before they can really get out of their present situation? Are we waiting for an impossible improvement, or can we really imagine the circumstances sufficient to allow their recovery?

Under several plausible assumptions for the next decade, various studies have concluded the debtor countries as a group can be expected to resume economic growth and bring down their debt burdens after an initial period of adjustment. Important factors in these analyses are industrial country growth and the level of international interest rates over the next five years. Decisive action on our budget deficit would not only be the single most effective means of countering the problem of high interest costs to debtors, but would better assure sustained growth in the United States economy, a major export market for these countries.

FEDERAL RESERVE BANK OF NEW YORK

Anthony M. Solomon
President

May 23, 1984

COPY

The Honorable William Proxmire
United States Senate
Committee on Banking, Housing, and
Urban Affairs
Washington, D.C. 20510

Dear Senator Proxmire:

I am enclosing responses to additional questions you posed on Argentina's debt financing package, as forwarded to me by Mr. Paul Freedenberg in a letter dated May 14. You also asked during the testimony for more information on reduced spreads and fees charged on loans to heavily indebted countries. Details of recent financings for five of these countries are also enclosed.

Please let me know if you have any further questions.

With best regards,

Sincerely,

(Signed) Tony

Attachment

cc: Mr. Ed Malan, Editor
Committee on Banking, Housing,
and Urban Affairs

RESPONSE TO SUPPLEMENTAL QUESTIONS
BY SENATOR PROXMIRE

1. You have described in your testimony the very adverse blow to the international financial system that was averted by the action taken at the end of March to provide $300 million to Argentina so it could pay the interest on existing loans. Can you tell us whether the Federal Reserve or the Treasury Department took the lead in arranging the agreements to aid Argentina?

   The government of Mexico took the lead in proposing the arrangements to aid Argentina.

2. Can you also tell us why if this matter was so important we did nothing until Mexico and the other Latin nations took the lead? Or were those countries prompted by the Federal Reserve or Treasury to suggest that action be taken to aid Argentina?

   The Federal Reserve has continuously monitored the progress of the Argentine negotiations with the IMF and the creditor banks. However, until the Mexicans and other Latin nations expressed a willingness to provide the credits, we did not see a way of avoiding the shift to nonaccrual status as of the end of March.

3. It is argued by some that if the banks had to write off portions of their foreign debt it would be a devastating blow to U.S. capital markets and would dramatically drive up U.S. interest rates. Others claim that the principal effect would be a loss of domestic market share by the major banks to the regional banks. Can you give us your views as to what would be the effect on U.S. interest rates if U.S. banks begin to write off larger portions of their foreign debt?

If U.S. banks write off significantly large portions of their foreign debt there would be upward pressure on interest rates as banks sought to cover their losses. In addition, there would tend to be a general contraction in credit availability, as banks became more cautious on decisions to lend to all borrowers. It is unlikely that the principal effect would be a shift of market share from major banks to the regional banks. Regional banks would need to increase their sources of funds in both domestic and international markets to meet additional loan demands. They generally pay a higher cost than the larger, more widely-known U.S. institutions.

SUPPLEMENTAL QUESTION FROM HEARINGS

At the hearings, Senator Proxmire requested additional information on improved terms on loans to heavily indebted countries. Attached are details on recently negotiated loans to Brazil, Chile, Mexico, Peru and Yugoslavia, each showing some improvement in commitment fees, interest charges, grace periods and maturities. (The detailed information is derived from various public sources and there may be minor discrepancies among these sources.)

Brazil

Improvement in Terms on Commercial Bank Debt

RESCHEDULED	1983	1984
Amount	$4.5 billion	$5.4 billion
Maturity	8 years	9 years
Grace Period	2 1/2 years	5 years
Interest Rate Spread		
over LIBOR	2 1/8%	2%
over U.S. prime (at lenders' option)	1 7/8%	1 3/4%
Rescheduling Fee	1 1/2%	1%

NEW MONEY		
Amount	$4.4 billion	$6.5 billion
Maturity	8 years	9 years
Grace Period	2 1/2 years	5 years
Interest Rate Spread		
over LIBOR	2 1/8%	2%
over U.S. prime (at lenders' option)	1 7/8%	1 3/4%
Facility Fee	1 1/2%	1%
Commitment Fee	1%	1/2%

May 21, 1984

Chile

Improvement in Terms on Commercial Bank Debt

RESCHEDULED	1983	1984
Amount	$3.41 billion[1]	
Maturity	8 years	
Grace Period	4 years	
Interest Rate Spread		
over LIBOR	2 1/8%	
over U.S. prime (at lenders' option)	2%	
Rescheduling Fee	1 1/4%	

NEW MONEY	1983	1984
Amount	$1.3 billion	$0.78 billion
Maturity	7 years	9 years
Grace Period	4 years	5 years
Interest Rate Spread		
over LIBOR	2 1/4%	1 3/4%
over U.S. prime (at lenders' option)	2 1/8%	1 1/2%
Facility Fee	1 1/4%	5/8%
Commitment Fee	1/2%	1/2%

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[1] Includes $1.175 billion in principal payments on medium and long-term debt, originally due in 1983; $1.0 billion in principal payments due in 1984; and $1.235 billion in short-term debt consolidated into a medium-term loan.

May 21, 1984

Mexico

Improvement in Terms on Commercial Bank Debt

RESCHEDULED	1983	1984
Amount	$18.8 billion[1/]	
Maturity	8 years	
Grace Period	4 years	
Interest Rate Spread		
over LIBOR	1 7/8%	
over U.S. prime (at lenders' option)	1 3/4%	
Rescheduling Fee	1%	
NEW MONEY		
Amount	$5.0 billion	$3.8 billion
Maturity	6 years	10 years
Grace Period	3 years	5 3/4 years
Interest Rate Spread		
over LIBOR	2 1/4%	1 1/2%
over U.S. prime (at lenders' option)	2 1/8%	1 1/8%
Facility Fee	1 1/4%	5/8%

1/ Includes $4.9 billion in principal payments on medium-and long-term debt, originally due in 1983; $3.8 billion due in 1984; and $10.1 billion in short-term debt consolidated into a medium-term loan.

May 21, 1984

Peru

Improvement in Terms on Commercial Bank Debt

RESCHEDULED	1983	1984
Amount	$380 million	$1.5 billion
Maturity	8 years	9 years
Grace Period	3 years	5 years
Interest Rate Spread		
over LIBOR	2 1/4%	1 3/4%
over U.S. prime (at lenders' option)	2%	1 1/2%
Rescheduling Fee	1 1/4%	3/4%

NEW MONEY		
Amount	$450 million ($250 million disbursed in 1983, remainder to be disbursed in 1984) same terms as the rescheduled amount	none asked

May 21, 1984

Yugoslavia

Improvement in Terms on Commercial Bank Debt

RENEGOTIATED	1983	1984
Amount	$1.0 billion	$1.2 billion
Maturity	6 years	7 years
Grace Period	3 years	4 years
Interest Rate Spread		
over LIBOR	1 7/8%	1 5/8%
over U.S. prime (at lenders' option)	1 3/4%	1 1/2%
Renegotiation Fee	1 1/8%	7/8%

NEW MONEY		
Amount	$0.6 billion	none asked
	same terms as the rescheduled amount	

May 21, 1984

JUN 1 1984

Honorable John Heinz
United States Senate
Washington, D.C. 20510

Dear Senator Heinz:

As a follow-up to your recent hearing on the Argentine bridge loan, I am happy to enclose detailed answers to the seven questions you sent me.

Since I testified before the Subcommittee, the Commerce Department has revised its forecast for U.S. exports to Latin America for this year, based on first quarter results which have become available. From the attached summary which I am submitting for the record, you will note that we are forecasting quite an increase to Mexico, our biggest market in Latin America, with a more mixed outlook for South America.

I trust that this information is helpful to the work of the Subcommittee.

Sincerely,

/S/

Joseph F. Dennin
Assistant Secretary
  for International Economic Policy

Attachments

Prepared by: P.B. Field, IEP/WH/OSA, x2435, 5/30/84, sgb
cc:
Dennin (2),
Good
Hughes
Field
Wang #33

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ

Q. 1. Lionel Olmer has said, "the brunt of developing country economic adjustment cannot be borne much longer by developing country trade accounts." The Commerce Department has proposed insulating short-term trade credits from the overall debt problem as a way to allow countries to continue vital imports in order to develop their economies to be able to export successfully. What specifically are your proposals in this area?

A. 1. Our belief has consistently been that short-term trade credit has played, and will continue to play, an important role in LDC trade and finance. The Commerce Department has taken an active role in demonstrating the importance of the trade/finance link since the onset of the LDC debt crisis. Our Senior Commercial Officers in the debt-constrained countries of Latin America have provided evidence that trade finance mechanisms have been disrupted by reschedulings and payments moratoria and that the private sector in these countries is having a difficult time getting foreign exchange or financing for imports. While the evidence is not systematic and the problem defies precise quantitative measurement, the Embassies' reporting is supported by research recently conducted by the Council of the Americas whose members account for over 80 percent of U.S. business activity in Latin America. The present uncertainty surrounding trade with the region is compounded by the actions of some Latin governments to lump trade credits into rescheduling of medium- and long-term loans, while others have set up special facilities to stretch out trade payments, such as FICORCA in Mexico.

The Commerce Department is particularly concerned about the impact on U.S. exports of the contractionary nature of trade adjustment underway in Latin America. This adjustment has usually led debtor countries to sustain large merchandise trade surpluses, which they have done by contracting imports substantially below earlier levels. Commerce believes that some way must be found once again to insulate trade credit lines from reschedulings and other aspects of the debt crisis if trade flows are to be maintained. Letters of credit and other trade obligations must be respected and must have a high probability of repayment if confidence in these instruments is to be restored. This is the only way that private sources will be induced to provide more trade credit on better terms. Commerce has stimulated discussion both within the U.S. government and with the U.S. private sector, particularly the commercial banks, multinational corporations and export trading companies to devise ways to insulate trade credits from the debt issue. Secretary Baldrige met with private sector leaders in October 1983 to foster such a dialogue. In late March of this year, Under Secretary Olmer chaired a follow-up meeting of government and business leaders to explore proposals and identify what can be done separately or together by the U.S. private and public sectors to help resolve the trade/finance dilemma. The debate is still in progress, and no final priority list of proposals has been drawn up. At this stage, the ideas receiving a measure of support appear to be the following:

Possible U.S. Private Sector Initiatives

- Modifications could be sought in rules administered by federal banking regulators that govern maximum lending exposure to individual high-debt countries. Specifically, banks could seek agreement that short-term trade credits would be excluded from calculations of their LDC exposure. The justification would be that short-term loans -- as opposed to BOP credits -- have a higher probability of repayment.

- On overdue non-bank trade credits, U.S. suppliers, particularly affiliates of U.S. multinational companies, could impress on those LDC governments that are currently uncooperative the importance of giving greater priority to paying key suppliers in order to insure continued shipments of vital goods to these troubled countries.

- Banks might seek regulators' approval for accepting interest payments in local currencies. Foreign exchange savings generated by this scheme would make it easier for LDCs to service trade lines at commercial rates.

- U.S. exporters could explore ways to help trade with Latin America move forward. Specific ideas include:

(a) reviving the secondary market for LDC trade paper

(b) taking equivalent local currency from importers and selling it at a discount to venture capitalists and bankers.

- U.S. commercial banks could develop a strategy for negotiating multi-year reschedulings instead of the present year-by-year approach. This would flatten the huge bulge in debt repayments coming due in 1985-87, which in turn inhibits lenders and investors from providing trade finance. Action by the banks could help significantly to reduce the present uncertainty which is inhibiting trade finance.

Possible Actions by the U.S. Government

- Official Trade Credits. The Export-Import Bank has hired an outside firm to expedite the processing of claims on unpaid trade credits under their insurance program. The U.S. and Foreign Commercial Service arm of the Commerce Department is working with Exim to implement pilot projects across the country and has set up trade finance coordinators in each of the Commerce regions to provide advice on Exim programs. Exim could further clarify its operating rules so that U.S. banks could better assess attendant risks in providing trade finance for exports to specific LDCs.
- The U.S. Government, through its influence in the International Monetary Fund, could encourage the debt-burdened LDCs as part of their adjustment programs to keep payments of trade credits separate from debt rescheduling.

Q. 2. What are the chances of reaching consensus between the banks, the suppliers, and the importing nations on the trade credit insulating scheme?

A. 2. The first steps are to reach a consensus within the U.S. private sector and within the U.S. Government on a priority course of action for insulating trade credits from debt rescheduling. Once this is done it should be possible to seek agreement with the importing nations of Latin America. To some extent, this is already being done. In a large number of reschedulings, short-term trade credits and other loans of short maturity must be repaid. Also, the contract cut-off date feature of reschedulings tends to favor trade credits. We anticipate that work will go forward on several fronts at the same time, at the private-to-private , private-to-government, and government-to-government levels. Progress at the government-to-government level is likely to vary within the region and depend to a considerable degree on the host government's perception of the magnitude of the trade financing problem. In several countries, for example, governments may be more likely to stress the need for increased financing for their own exports.

Meanwhile, since October 1983 the United States has been participating in regional discussions on the LDC debt problem, including trade finance, within the Organization of American

States. A special committee of the OAS is currently reviewing several groups of proposals including ways to expand official trade finance, and possible bilateral and/or multilateral compensatory agreements to stimulate regional trade. We think it is important to encourage the Latin American countries to achieve a consensus among themselves on trade finance, so that orderly progress can be made. A Latin American consensus would in turn facilitate a broader consensus with banks and suppliers.

Q. 3. Would insulating trade credits run the risk of leaving debtor nations unable to pay interest payments on bank loans, since the country would have insufficient foreign exchange left over? Would the Commerce Department's plan to allow remaining interest payments to be made in local currency into a blocked account until foreign exchange becomes available be acceptable to banks?

A. 3. Commerce recognizes that to successfully insulate trade credits from LDC debt problems would be a formidable task. We are currently studying the issue but do not yet have concrete proposals. One proposal which has been made to us is to allow LDC interest payments to be made in local currency into blocked accounts until foreign exchange becomes available to make payments. The hard currency interest savings generated could then be used to meet trade credit obligations on a timely basis. Various legal, regulatory and practical problems would be inherent in implementing this proposal on a large scale and we are currently studying the implications.

Q. 4. What is the Commerce Department's attitude on "innovative" or "alternative" financing mechanisms, such as barter, clearing arrangements, and countertrade?

A. 4. Given the current pressures on the international trade and finance systems, both LDC as well as DC firms and governments have sought a variety of alternative financing mechanisms to maintain trade and avoid economic paralysis, including countertrade, barter, clearing arrangements, and soft currency transactions. The U.S. Government views such trade as generally inefficient, often trade-distortive, and potentially leading to serious disruptions in normal trade flows. Nonetheless, the U.S. Government recognizes that at times use of these mechanisms may be the only way to maintain essential trade in the present financial environment.

While many LDCs believe there are advantages to such forms of trade, they often overlook some of the more harmful effects. Among the more serious of these in the long-run may be higher costs and systemic effects such as trade constraints deriving from government interference in trade and the general politicizing and bilateralizing of trade. The U.S. Government is particularly opposed to government-mandated countertrade, which directly subverts free market principles to which all OECD member governments subscribe. That is one of the main principles underlying U.S. government policy on countertrade --

each countertrade transaction should be decided on its own economic merits where all parties participate voluntarily, without pressure or rigid performance requirements imposed by governments.

Clearly, the way to minimize the problems LDC countertrade poses to the international trading system is to resolve the underlying causes and reestablish confidence in normal trade finance mechanisms. All OECD governments recognize the need to sustain economic recovery in their countries and open markets for LDC exports. In addition, OECD governments have supported IMF/LDC adjustment programs balanced by financial flows from banks and official creditors. However, the process is likely to be a lengthy one. In the interim, the private sector in LDCs must have access to financing for needed imports if these countries are to recover, repay their debts, and avoid the short-term allure of practices like countertrade. A major element in resolving all these problems is to reestablish adequate financing for trade between developed and developing countries, perhaps through insulating trade financing lines from other aspects of the LDC debt problem.

Q. 5. Since protectionism is fueled by an influx of cheaper goods, and the possible link between innovative financing methods and such an influx of goods has been noted, do you believe insulating trade credit sufficiently guards against such a development?

A. 5. The proposals we are reviewing for insulating short-term credits from the overall debt problem are targeted to restoring U.S. export levels. We understand that several Latin American countries are seeking support for using resources from international financial institutions to supplement scarce foreign exchange for their exports. The World Bank and Inter-American Development Bank have been identified by these countries as potential sources of support for such programs.

Any proposals that emerge from the preliminary informal discussions underway in the U.S. private sector and U.S. government trade agencies must take into account the impact of expanded trade credits for the debt-burdened LDCs on their own export expansion programs, so that protectionist pressures are not simply exacerbated in the DCs.

In the interim, it should be noted that products imported under innovative financing methods, such as countertrade, are equally subject to U.S. trade laws against unfair foreign trade practices. This guards against countertrade providing a tool for hidden price cutting or dumping of otherwise unsaleable products.

Q. 6. Given the alternative between Argentina developing an IMF program, or failing to do so, which situation is more favorable for U.S. exports? This is key because more and more U.S. jobs are tied to exports. This issue must be kept at the center of the debate.

A. 6. It is our view that Argentina's success in working out a program with the IMF would be beneficial to reactivating U.S. exports to Argentina. First, a sound adjustment program would lay the basis for stable economic growth. This is the most important factor over the long-term in restoring higher levels of imports into Argentina. Second, an IMF agreement is a prerequisite for the Argentine government to successfully complete foreign debt rescheduling with private foreign banks. Until these negotiations are concluded, commercial banks are unlikely to provide necessary short-term trade credits or other trade financing. Third, the IMF will probably insist on some liberalization of the Argentine import regime, possibly the prohibition on imports competitive with local industry. Finally, an IMF agreement should lead to a restructuring of official debt, which may lead to a resumption of Eximbank support for American exporters competing for major contracts in Argentina.

Q. 7. It is known that Argentina placed a higher priority on paying trade obligations than interest payments in the months leading to the negotiations. In your view, would the Argentinian situation be more positive, both for the banks and Argentina, if a trade credit insulation program was in effect during the period?

A. 7. In effect, the Argentine Government has to some extent already insulated trade obligations from interest payments in order to maintain levels of essential imports. While there is still a 2-3 month delay (past due date) for Central Bank allocation of foreign exchange for commercial payments, these arrears are gradually being reduced. As the arrears are eliminated, private banks are generally rolling over the amount repaid into new letters of credit but they are not increasing exposure. While Commerce does not yet have clear-cut proposals on how to achieve a trade credit insulation program, it is evident that the current Argentine priority in meeting commercial payments has contributed to maintaining some private bank trade credits.

Wang #51
5/14/84

REVISED FORECAST FOR U.S. EXPORTS TO LATIN AMERICA--1984
(BASED ON FIRST QUARTER RESULTS)
$ billion

	1982	1983	% cng	USDOC est. 1984	% cng
Mexico	11,025	8,755	-21%	11,500	+31%
Caribbean Basin	6,339	5,889	- 7%	6,503	+10%
Argentina	1,268	931		900	
Bolivia	98	47		47	
Brazil	3,423	2,557		3,000	
Chile	925	729		800	
Colombia	1,857	1,471		1,304	
Ecuador	800	565		810	
Paraguay	73	34		30	
Peru	1,117	900		800	
Uruguay	180	84		50	
Venezuela	5,061	2,668		3,335	
Sub-total South America	14,802	9,986	-33%	11,146	+12%
TOTAL LATIN AMERICA	32,166	24,030	-23%	29,149	+18%